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TAXATION *and* MUNICIPAL FINANCE

THE CONTRIBUTION *of the* ACCOUNTING PROFESSION *to* TAX ADMINISTRATION

1937 CHANGES *in* NEW YORK STATE TAX LAW

OBLIGATIONS *of* NEW YORK STATE EMPLOYERS *under* UNEMPLOYMENT INSURANCE LAWS *of* OTHER STATES

PANEL DISCUSSION *on* FEDERAL TAXATION

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Objects of the Society

"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public; to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects; and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

—*From the Certificate of Incorporation.*

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THE NEW YORK STATE SOCIETY OF
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Taxation and Municipal Finance

By A. A. Berle, Jr.

PUBLIC finance has become a major issue in American public life.

Clear thinking requires sharp division of municipal and state finance from the federal problem. This is because the federal government has the power to create its own credit. States and municipalities do not. It follows that the financing of a state or a city must be classic in form. In a word, budgets must be balanced; revenue must be sufficient to carry current expenses and also the service on debts.

The federal government is not under this compulsion. We are dimly learning that the finance of a national government, which in turn is allied to its currency creating power, is, properly speaking, not finance at all. It is a method of apportioning claims on the national income stream. Further, it is a method by which supplies of goods, services, production and income which are locked up by the economic process, may be unlocked and transferred to groups which may need those goods or those services; or be applied to national needs, such, for instance, as the expenses of war. This helps to explain a famous phenomenon. Economists and financiers in 1914 figured out that the laws of classic finance would not permit the Great War to continue more than a few months. Yet it actually continued nearly three years before the resources of the United States were brought into full action; and it could have continued, so far as finance was concerned, some years beyond the actual date of the Armistice. National will, for a time certainly, can release nations from the limitations of classic finance; this is happening today in Germany, Italy and Japan. How long the process can go on remains problematic: a Marxian Socialist will contend that it can go on forever; the classicist insists that ultimately a day of reckoning comes. I am not asked, and do not propose, to attempt to resolve this question today. But I do wish to make it very clear that the principles hereafter laid down as to state and municipal finance do not necessarily apply to national finance, and may not apply at all.

In national affairs, there is only one test of sound finance, and it is not a banker's test. The test is whether the national financing is so handled as to secure a maximum of national production, and a maximum of satisfaction of national desire with that production. A classic national finance which resulted in having a tremendous amount of production stopped, a tremendous amount of goods on the one hand; and a tremendous amount of needy people looking at them on the other, with neither jobs nor goods, and an apparently unbreakable plate glass window in between, cannot be described as sound finance, on any theory. Nor, in my judgment, will the political forces, loose at the time, permit any conception of national finance except one which conforms to the definition I have just given. Finance is a servant, not a master, wherever you find it. In national affairs, the possibilities of finance are only beginning to be explored.

But it is otherwise with states and, in the east more importantly, municipalities. These have not the power of creating credit. They cannot print money. They cannot create banks and force banks to buy their bonds, creating therewith bank deposits

Presented at the November, 1937 meetings on taxation of The New York State Society of Certified Public Accountants.

which can be currently drawn upon. It is probably desirable that they should be thus limited. For, if forty-eight states and a host of municipalities had this power, the credit currency system would be chaotic. There can be only one credit and currency system in a country; and that system is by hypothesis national. Were localities to have that power to any extended degree, the result could only be confusion. Where, therefore, the extraordinary resources of a country have to be stimulated, drawn on, or transferred by a credit-creating process, this must be in charge of the federal government, no doubt using the local agencies to the fullest extent possible. In practice this means that where extraordinary situations have to be met, or a new policy in national production has to be inaugurated, the municipalities must appeal to the national government; exactly as the State of New York and the City of New York appealed to the national government in 1933 and afterwards; exactly as Mayor LaGuardia and the associated municipalities are appealing to Washington today, to handle relief and public works. A question of policy is there referred to the sovereign power creating, controlling, expanding or withdrawing credit. The Federal Reserve Board and the Treasury are the logical and necessary places in which that determination has to be taken. We shall ultimately learn the trick of so handling national finances that the national income can be steadily increased; that at no time shall we have the paradox of a need on one side of the plate glass window and a store of goods on the other side; that never shall we have the insane situation of men who need jobs on one side of the town, and a factory adequately organized and stocked with available raw materials on the other, which would like to work and cannot. But this is not primarily a municipal problem, save as municipalities pool their interests and influence the national policy.

On the strict municipal side there are two major principles always in force. The first is that a municipality has no business to borrow at long term for recurrent expenses. You may recall that the first decision Mayor LaGuardia took—and a difficult decision it was—was that of increasing current taxation to pay the current expense of relief. In this Mayor LaGuardia reversed the policy which had been laid down by Governor Lehman of financing relief through bond issues; and he was even forced to discard the advice of at least one excellent expert on taxation. But he was right; and the event proved it. For relief is a current expense.

On the other hand, municipalities are justified in borrowing when that borrowing results in a direct increase in tangible wealth. We are wrong in thinking that wealth is only that sort of goods which produce other goods and result in a mercantile profit. Central Park, is, for instance, one of the great resources of New York City. It does not produce a profit, and never will. It produces enjoyment, instead. Yet enjoyment satisfies a human need just as much as a plate of pork and beans. It is justifiable, accordingly, for a municipality to incur a long term bonded debt for assets which steadily supply a human necessity, as, for instance, parks, schools, playgrounds, hospitals, bridges, roads.

The principal rule is, of course, that the life of the bond shall be less than the life of the asset; and that the service of the bond shall be in reasonable relation to the amount of enjoyment derived.

In like measure, a municipality is entitled to finance for productive investments: power plants, street railways, and the like. But there is a difference in this kind of financing. Some kinds of services are so completely collectivized that there is no

possibility of assigning a particular debt to a particular group of properties; streets, parks. Many enterprises have not reached this phase and may very well never reach it. The water service, the street railway services, the utility services, fall in this class. Municipal enterprise here contributes two elements. It can break the ironclad grip of a monopoly on the life of the town, and incidentally free the town from an endless lot of political influence. It can also make possible the handling of rates so that the service can be cheapened. But in general, the principle of assigning a particular debt to a particular productive property rather than to the city treasury as a whole stands up. For one thing, it is useful in requiring these advances into the field of collective ownership to stand on their own bottom; and one way of doing this is to have them meet, so far as possible, their own debt services.

We start, then, with this major principle: current expenses should be currently met. Bonded indebtedness should be incurred only for tangible accretions to wealth, either acquired or created; but, of course, preferably the latter. For all government shares the responsibility for the continuous creation of wealth.

Between these two there is a gap. This is municipal short term financing, which actually means merely borrowing money today to be repaid out of taxes you expect to collect tomorrow. If cities were well run there would be little or no need of doing this. Theoretically, a municipality, like a business, ought to have enough cash in the till so that it can go forward from one tax collection period to another without borrowing. Actually, this has not been the practice. I came across one grotesque incident. When the City of New York absorbed the City of Brooklyn, Brooklyn was in such shape that it collected its taxes in advance and borrowed no money for current purposes. The City of New York was not so fortunate; it borrowed the money each year and repaid the money as it collected taxes. The politicians had a bright idea. They decided not to levy taxes in Brooklyn that year, so that Brooklyn should be as far behind as New York—which was popular with the taxpayers. Since that time, the greater city has quite commonly gone into the beginning of its tax year with no money in the till; has borrowed steadily until the six months installments of taxes were paid; has then paid off its notes at the bank and has started over again. Under the so-called Bankers' Agreement in 1933, the City was required to set aside a so-called "bankers' reserve" which required the City to collect more in taxes than it expected to spend; and pile that up as a reserve of cash. Continued over a long period of time, such reserves would eventually amount to cash enough to meet a half year's requirements; and in that case the City would merely use this cash to meet its current payrolls and expenses, instead of having to borrow. We have continued that policy. Though the Bankers' Agreement has expired, that policy was sound and should be continued; for it is the only way by which a city can ultimately free itself from the necessity of going, hat in hand, to the banks and borrowing for its daily needs. The time should come when cities like New York will not have to be continuously in the money market.

Connected with this is the whole subject of the so-called sinking funds. This is another bridge between the long term, or bond, finance and the short term, or note, finance. Whether it ought to be a bridge, is another story. Everyone knows what a sinking fund is. It is a plan by which, whenever a bond issue is floated, there must be set aside not only the interest on the bonds in each year, but a little additional cash

which, added up throughout the years, and invested at interest throughout the years, will retire that issue at maturity. The catch comes in the last phrase. The sinking fund cash has to be invested; for otherwise the cash would simply pile up without bearing interest and the city would lose the advantage of the interest itself. But how to invest this cash? Theoretically, the cash ought to be used to buy or call in the open market the long term bonds which are to be paid off by this sinking fund. Unfortunately, most municipal bond issues are not callable; though they ought to be, so that the city, like any other borrower, can take advantage of lower interest rates by refinancing operations. But municipal sinking funds are commonly not so restricted; and more than once when a city was hard up it has "invested" its sinking fund cash by buying its own short term notes. This is another way of saying that the city, having to borrow short term money, borrows it from the sinking fund and puts in an I. O. U. which is quite all right, if the I. O. U. will be paid at maturity; and quite all wrong, if the I. O. U. is not going to be paid but is going to be extended. Because sinking funds have been "raided" in this fashion at various times, many students insist that long term municipal bond issues ought not to have sinking funds at all; but that they ought to be serial—that is, a portion of them should be retired in each year. Serial financing is certainly both more honest and more rigid than the old line sinking fund type of bond; and more in the classic tradition. It is questionable, however, whether that type of financing can be easily applied to a very large city. New York, for instance, has a budget and debt situation second only to that of the government of the United States. If we were testing our size by the size of our budget and our bond issues, New York would rank financially just after the great powers of the world. Strictly rigid financing does not altogether apply to situations of this size; for, in depression years, the economics of the city may call for a lightening of debt payment; while in boom years pressure should exist to pay off the debts created. My point, of course, is that wherever sinking fund monies are used for short term requirements, they should be rigidly accounted, not as "an investment" and "investment" of sinking funds, but as an addition to the short term debt of the city; and should be treated, to all intents and purposes, as a deferred payment to the sinking fund. Any other course permits a city, and that limited but valiant section of the public which interests itself in municipal finance, to deceive itself.

Taxation. Thus far we have been talking elementary municipal finance on the borrowing side. But how about the revenue side?

Taxation is perhaps the most complicated single subject in government. The standard maxim, "Get your revenue where you can", was almost the beginning and end of wisdom on the subject until a few decades ago. Today we are learning.

Historically, our principal source of municipal revenue is the land tax. This really goes back to feudal times; and remains, because, of all types of wealth, land is the one variety which cannot be hidden. There is also considerable basis for the economic theory that land is the ultimate source of all of the wealth of the city; or, from a different angle, every wealth-creating enterprise in a city has some basis in land and can therefore be tapped through the medium of the land tax, which is promptly passed on by the landlord to the rent payer. I say passed on; but this is a generality. In times of great depression, or in times when there is an over-supply of real estate, the passing on process becomes impossible; and real estate suffers.

The centralization of the tax burden on real estate has been the subject of a tremendous outcry. Much of it is justified; though I should like to make one observation here directed not to municipal finance, but to the real estate owners. As we know it, the real estate industry in New York City is on a wholly false basis. It has been assumed that real estate could be owned and held safely on the basis of a two-thirds mortgage and a one-third ownership; further, only the merest fraction of real estate owners actually charge and set aside in cash a depreciation fund which takes care of the growing age of their buildings. No industry in the world can safely be run on that basis. A merchant, for instance, who tries to operate without charging depreciation, and with a perpetual mortgage equal to two-thirds of the value ahead of him, would go bankrupt about every seven or eight years. Real estate owners seem to think that they are immune from this process. They have been immune largely because land values have risen steadily up to the present. But there is no reason to suppose that land values will go on rising forever—probably it is well if they do not—and this unearned increment which has saved the real estate industry from its own errors cannot be counted on with the same certainty as it was from 1870 to 1929. Naturally, when taxes rise, the combination of increased taxes and the mortgage interest put the real estate owner in a position where he can easily be wiped out—as he was, in quantity, during the depression from 1929 to 1934.

The land owner is right, however, when he raises his outcry against municipal waste. Actually, the taxes he pays benefit him when they go either to pay current services which add to the attractiveness and safety of the city, or to pay interest on bonds which have created additional wealth within the city. When, however, they merely go to take care of political graft or waste, the land owner is squarely in line of fire; and unfortunately, municipal government has not a high record either for efficiency or for honesty.

In an effort to escape that, there have been proposed constitutional limitations forbidding the taxation of property more than a stated per cent of its value. Such a constitutional amendment is being urged in New York State now. Yet to pass it would be suicidal. I came across the case of a middlewestern city which came under a constitutional limitation on the land tax. It had no other basis of revenue; for sales taxes and privilege taxes (leaving aside their economic desirability) have only a limited use. As a result, the city had not revenue enough to meet its needs. But governments do not shut down on that account, and what happened was exactly what you might expect. A service charge was levied for practically every municipal service: for street lighting, for garbage disposal, and the like. In the end, I think the land owner paid more than he did before. Salvation does not lie that way. The only salvation lies in taking an active part in public life; and in making sure that the city is effectively and honestly run. It may be noted in passing that the land owner will benefit almost as much by seeing that tax money is well spent as he does by actual reduction of taxes. There has been relatively little variation in taxes in the City of New York in the past four years; yet whole areas are on the way to being salvaged because the city's expenditures operated to make those sections more desirable and more useful. This reflected itself at once in an improved real estate market. Were we, for instance, able today, as I hope we may be soon, to spend a relatively few millions of dollars in taking down the Sixth Avenue elevated line, the result would be to make an entire strip of the island of Manhat-

tan more desirable and to raise real estate values all along the line. Taxpayers would pay more taxes, probably; but they also would be able to pay more taxes; and they would have an increased revenue from their buildings.

It is my belief that we could today undertake the long process of revising our tax structure. In New York State, for instance, 72% of state and local revenues are derived directly from land, leaving the other 28% divided among the income and inheritance taxes, license taxes, and other similar taxes.

The Twentieth Century Fund, in a recent study on current tax problems, came to the conclusion that taxes amounted to about one-fifth of the national income; that no one escapes making a substantial contribution; that by the time any income reaches $100,000, at least half of that income is diverted into taxes. They further came to the conclusion that state and local expenditures will continue for the next four years, at least until 1940; but they likewise came to the conclusion that the property tax probably offers little possibility of immediate expansion. If this is true, the level of financial ability required in municipal and state financing will have to increase very materially. There has been entirely too much haphazard taxation in the last few years. How to change this? No one interested in his political career will undertake to reorganize taxation, if he is wise. With only a limited experience in trying to work out and collect new revenues, I know to my cost the pressures of all kinds to which an official is subjected as soon as he touches this field. Yet, plainly the job has to be done. Further, it has to be done by the state; for beyond all else the state government is responsible for the handling of its tax affairs.

I should like, accordingly, to see a special commission appointed, directed towards re-arranging the tax program of the State of New York. That commission would have several jobs to do. It would have, first, to take all of the sources of revenue we now have; and to work out the various duplications. It ought to be possible to divide the various fields of activity; so that the state had its bases of revenue; the municipalities had their bases of revenue; and where these overlapped, a suitable division could be made. Liberty in imposing and collecting taxes is an essential part of local government and an essential check on waste. No government is ever as careful about spending money as a government which has to raise the revenue. Consequently, the result aimed at should be that no expenditures can be enforced by any governmental body, unless that governmental body is prepared to raise the revenue necessary to meet those expenditures; but the fields from which that revenue can be raised ought to be charted out in advance.

Plainly, the land tax will remain a municipal tax. In the nature of things it can hardly be otherwise. Plainly, the income tax will remain a state form of revenue; for no municipality can effectively levy an income tax. If sales taxes are to be continued at all—they are not, in my judgment, a desirable form of tax—they must be considered as in the nature of a supplement to the income tax; for that is what a sales tax really works out at. Within various limitations, these types of tax could be assigned; and so far as possible the general state taxes ought to be assigned to state functions; the local taxes to local function. You will say this is a dull subject. Well, perhaps it is. And yet—to those of you who are New York residents—I could put it more violently. I could say that as Chamberlain of the City of New York I have a first mortgage on each and every one of you for approximately $110 per year; that no one

can get out of this room until I have taken away from him, in one form or another, that amount of money. You do not see me doing it. I do not have to steal your wallet or arrest you at the door. But the process is certain.

We are beginning to understand capital budgets, though they are by no means successful. We are beginning to understand planning, which is another way of budgeting in advance. We are slowly coming to the point where at long last we will adjust our taxation also. It will then be found, I think, that the local or classic finance can make headway only as it is done against a frame of complete understanding of real government functions.

Returning to the place or point of beginning, let me say that this frame will largely be made by a national government. For in the long run, finance and taxation are a function of the economy of localities; and the economy is today a national, not a local, affair. Fundamentally, we shall still be faced with the problem of what national finance and national taxation and national credit creating can do and is supposed to do in the creation of income and wealth.

The Contribution of the Accounting Profession to Tax Administration

By Mark Graves

BEFORE I bite into the subject assigned me, I desire to make a few preliminary remarks. I make these in the spirit of friendliness and of advice. I have watched the work of your Society for a good many years. As far back as 1919 when Isidor Sack and I were engaged in organizing for the administration of a new income tax, a committee of this Society rendered us very valuable assistance. I do not see any of the men here tonight who served on that committee, but they were of very great help to us.

My observation is that your Society is too modest, too self-effacing, too reticent, and too loath to claim for yourselves the recognition to which you are entitled. Let me amplify those remarks somewhat. I presume no other group of men in the State of New York know so well the deficiencies and the defects in the state tax system or the Federal Revenue Act or in their administration. I presume no other body of men understands better the economic effect of our taxes and in many instances their undesirable economic effect. I know perfectly well that if I should come to your Society, as I did several months ago, and ask you to create a committee to study the matter and give me advice, you are perfectly willing to do so.

I would like to have you consider whether or not the Society's Federal Tax Committee should not volunteer its suggestion and recommendations, to federal authorities and correspondingly your State Tax Committee offer the same service in respect to state matters. Speaking for the tax authorities of the State of New York, and in a sense for the Administration, we will welcome it. We do not pretend that we are "all-wise." We realize perfectly well that we do not know fully the economic consequences of some of our taxing statutes. We realize full well, although we have consulted with committees of your Society, and received very valuable assistance from them, that some of our rules, regulations and our requirements probably impose unnecessary hardships on the taxpayers.

Taxpayers of the State and Nation not only have to pay huge tax bills, but in addition, they are required to expend large sums as the cost of tax compliance. Frequently new records must be kept, taxes withheld and numerous complicated and difficult returns filed. Such meager studies as have been made indicate that the cost to taxpayers of complying with all of our tax laws amounts to as much as one billion dollars annually. It would not surprise me if that is so.

Here is where you accountants come in. We would like to have you feel that our door is open, that you can come to us without our saying that you are horning in on something that is none of your business, or having your efforts resented. We would like to have you feel that you can come to us with your suggestions and proposals. Quite likely, for reasons which will not occur to you, we cannot accept all of them, but I can assure you that they will all receive thoughtful and careful consideration.

I want to further add, that in the organization for the administration of all recent taxes we have consulted

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and advised with committees of your organization. I frankly admit that the administration of tax laws in this state is better than it would otherwise have been because of the advice, assistance and cooperation we have received from your organization through the committees which have represented it.

I am asked to speak tonight on the accountant's contribution to tax administration. I feel that I am somewhat qualified to do that, qualified because I have been a tax administrator for a couple of decades, at least, and have been in public finance work even longer. In addition, I have had many contacts with public accountants, both through your organization and individually. Moreover, I feel that I can speak with some authority because I am not an accountant myself. On the other hand, I am a member of the legal fraternity, so I am not prejudiced in your behalf.

Accountants have rendered in various ways valuable services and made notable contributions to tax administration, both in the federal and state fields. In the first place, you make a contribution when you install a system of accounts for a business establishment or a taxpayer which enables him to disclose frankly and fully and clearly his taxable income. You not only render a service to him, but at the same time you render a service to the government. Moreover, you aid and assist government when you prepare the taxpayer's returns after analyzing his accounts and present the data in such fashion that the audit of the return is relatively simple and easy.

Having prepared the report, your contributions to tax administration are supplemented when called upon by supplying the data and information which is required and explaining in conferences, at informal and formal hearings the items set forth in the returns which you have prepared.

I doubt if you fully appreciate what a relief it is to the tax administrator to know that public accountants, men of your profession and Society, are preparing ordinarily the more important returns that come to us because in the last analysis, the tax administrator has to accept many things on faith. Many times he judges of the accuracy of a return by the man who prepares it, or the man who comes into conference representing the taxpayer. We come to know even better than you may think that from one accounting firm or another, from one individual accountant or another accountant comes information upon which we can depend.

The cost of administration to government would be increased very perceptibly except for the contribution which accountants make in that direction, first, of establishing appropriate sets of accounts; second, in making returns; third, in supplying the supplemental information; fourth, in explaining the returns if called upon at conferences or informal or formal hearings.

In recent years, there has arisen considerable discussion concerning the practice of law by accountants. I intend to touch on that subject as I see it and as it appears to me as a tax administrator.

Nowhere in our statutes is the term "practice of law" defined. There have been a variety of judicial decisions bearing on certain aspects of the subject, but I have been unable, from an examination of as many of those decisions as I have had time to examine, to find out what "practicing law" actually means. I have come to the conclusion that there is a great deal of loose thinking and I might add, loose talking on the subject. The accountant in the tax field is a visitor of relatively recent origin. Prior to the turn of the century, the federal government financed itself principally through the tariff and through excises such as liquor and

tobacco taxes. Neither called for a high order of technical accounting training or experience. No great difficulties were encountered in the preparation of returns. State and local taxes consisted principally of the general property tax on real and personal property. True, we had an inheritance tax at a low rate, and some few minor excise taxes.

Prior to 1900, there was little accounting work in the tax administration field, and, therefore, your profession was virtually a stranger to that field, but as the country has developed, as our social and economic conditions have become very much more complex and as the cost of government has risen, government has had to resort to other styles of taxation—such as income taxation for persons and corporations, higher estate taxes, and a great variety of taxes of the sales variety, and to cap the climax, the undistributed profits tax inaugurated by the Federal government. I need not tell you men, you realize it better than I, that in that variety of taxes, accounting is a very important factor. In fact, without proper accounting procedure, neither the taxpayer nor the government can determine the amount of the taxpayer's liability. Therefore, it was essential that your profession be brought into the field, essential both from the standpoint of the taxpayers on the one hand and the government officials on the other.

I recall having studied bookkeeping when I was in high school. About all that I can recall from my study of the subject is the impression I formed that bookkeeping, accounting, is merely writing history, writing the history of the transactions of a business enterprise. You could jot down, of course, in a journal, each transaction as entered into, (by a journal I do not mean the journal as used in the bookkeeping sense) but business establishments, some of them, are of such vast size that the arrangement of recording transactions has a great deal to do with telling the story—of writing the history—so that it can be read and understood. There is where you men have come in and developed the technique of accounting, so that it will show not only what business transactions a man had, the volume of them, and whether he made or lost money during the year, but, as these new taxes have come along, also disclose certain data essential to the preparation of returns. You have introduced techniques, supplemental records, and what-not, so that at the proper time the required data may be produced at the minimum cost to the taxpayer and with the highest degree of accuracy.

I do not know what the taxpayers and the government would have done if there had not been a body of men trained in that technique. It is quite as important a technique as the skill of the surgeon, which, as we all know, has been improving during the past decades. There has been a challenge to your profession to develop new techniques fast enough to keep apace with the new requirements of government in the various fields of taxation, and perhaps otherwise.

It follows, of course, that, if you accountants are to develop accounting methods, and establish systems of recording the financial and other transactions of business enterprises that tax returns may be made out, that you must be familiar with the laws, the regulations, the rulings, and the decisions under those statutes. Otherwise, you can't know whether the accounting system which you have devised will enable your employer to produce when tax returns are due, the various items of required data. Your employer cannot be expected to hire a lawyer to tell him what kind of an accounting system he needs and what accounts should be kept and then come to you and say "Here is a set of specifications that my lawyer has

prepared as to what my accounting system should disclose." He needs you to go ahead and prepare that kind of accounting system. It is no more to be expected than, for instance, if you hired an architect to build a house for you somewhere. The architect is supposed to know all the zoning laws, all the building restrictions and codes and what-not; he is expected to know whatever features of the building code in the locality apply to plumbing, heating, electric wiring and so on. A man who plans to build a house does not hire a lawyer to advise him what kind of plans and specifications the architect should prepare.

I might further illustrate by taking the case of the plumber and electrician, among others, but I think I have said enough to demonstrate the point I am attempting to make, namely, that you men must know the tax laws, and the rules, regulations and decisions concerning them. You are no more practicing law when in your work of devising and installing accounting systems you apply that knowledge than is the architect who applies his knowledge of building laws and building codes and regulations, or the plumber who is familiar with the laws and ordinances and codes applying to his business.

Now it comes down to the question of making out returns. Obviously, the men who have devised the accounting system, who understand the meaning of accounting terms, and of accounts and what they should contain, are the natural and logical men to make out tax returns. And having made out tax returns, if their clients receive letters (and I am sorry to say that we always write some letters) it is a perfectly natural and obvious thing for the accountant who devised the accounting system and made out the return, to undertake to explain the items contained in the return. And I do not think that is practicing law either. If in the explanation of them he says, "My understanding of this law or this regulation or this ruling or this decision is so-and-so," still I do not believe he is practicing law, certainly not in any practical sense.

Then he is called into conference, informal hearings, and such, and again as a matter of practical administration, as a matter of the conduct of business, I fail to see why it should be necessary for the client to hire a lawyer to talk about the law, and an accountant to talk about the accounts. That just sounds ridiculous to me.

Remember, I have told you I am speaking as a professional lawyer to a group of professional accountants, and I do not undertake to say what practicing law and practicing accounting may mean in other fields than tax administration; I am merely trying to tell you from my own experience in tax administration, covering a good many years, what I think of the matter.

I believe the accountant is the man who is more concerned with finding out what the facts are concerning the business and of setting them up so that he and everyone else can understand them. In other words, presenting them in the most understandable way, regardless of how they may affect his clients' finances, or the results so far as the state is concerned. The lawyer has a little different slant. You know we lawyers are officers of the court. We have to do what the courts tell us. If the judge says to the lawyer, "You defend this man," the lawyer has no choice; he must defend that man even though he believes and perhaps knows the accused is guilty of the offense. Therefore, the lawyer's approach is somewhat different. He is not so much concerned ordinarily with finding out what the facts are and presenting them in an understandable way; he is the advocate, he is the one employed for this particular job, and in one case he may argue

one way today and next week he may be arguing precisely the opposite in another case. Under the code of ethics of the legal profession that may be done with propriety.

So if I were to outline the field, if I were to undertake to set up a fence and draw a line, I would say the line should ordinarily be drawn at the point where in a tax case you have gotten beyond the filing of the return and the explanation of it, the conference and the informal hearing, but you are coming down to the part where a record is going to be made which may be used as the basis of reviewing the decision in the courts of the state or nation. From the time that record starts to be made, I think the lawyer should be consulted, because he is the one who is to carry the matter through the courts and he should be present while that record is being made and have a large hand in shaping it.

Now, there may be exceptions to that rule, but that is the closest approach I can make to pointing out from my own experience, based upon observation, and I like to think some practical sense, as to just where the line of demarcation should be drawn.

1937 Changes in New York State Tax Law

By Leo Mattersdorf, C. P. A.

THE newspapers have already acquainted us with the fact that the Legislature has extended for another year the higher corporation tax rate, the emergency personal income tax rate, and the unincorporated business tax.

Much has been written about the passage of an act specifically taxing the salaries of state judges and certain other public officials whose compensation had heretofore been treated as exempt, but there were other changes in the tax law by this year's Legislature which are important, but which lack the element of human or political interest to warrant the giving of space to them by the daily press.

In the field of corporation taxes, the 1937 enactments were more far-reaching than in the field of the personal income tax. Let us, therefore, first consider the corporate franchise tax. Heretofore a foreign corporation coming into the State had to file a report after it had done business in the State for thirteen months. On the basis of the information therein contained, the license tax was levied. For many reasons this was unsatisfactory. Under the new provisions, the tax is now called a fee, and there is eliminated from the law the requirement that it is to be computed on the basis of the capital stock employed by the corporation within this State during the first year of carrying on its business here. The license fee will be computed on information to be furnished in a corporation's franchise tax return filed pursuant to Articles 9 and 9-A of the tax law.

Beginning January 1, 1938, taxes under Article 9 must be paid at the time the returns are filed. Heretofore, in the case of a real estate corporation, for instance, returns were filed, and a notice of assessment from the Tax Commission was awaited. Thirty days then were allowed to make the payment set forth in the notice of assessment.

Hereafter if a tax is not paid at the time the return is filed, penalties will accrue. In the case of corporations which file their federal income tax return on the basis of a fiscal year ending after February 28, and prior to July 1, the report under Article 9-A is now due four months after the close of the fiscal year. This is a distinct improvement over the old rule which required that such franchise tax returns be filed within thirty days after the federal return was filed. In meritorious cases, the Tax Commission is empowered to grant extensions.

Probably the most important change made in the franchise tax law is that dealing with the due date of taxes under Article 9-A. The law, as it stood prior to the amendment this year, provided that one-half the tax but no less than twenty-five dollars had to be paid at the time of filing a franchise tax return, which in most cases is due on or before May 15, while the balance, if any, was due within thirty days after the date of the bill sent the taxpayer, but no earlier than January 1. If the taxpayers' bill for the remainder of the tax was dated March 15, let us say, he had until April 14 to pay. Collection of the balance of the franchise tax, therefore, depended on how fast the Corporation Tax Bureau could audit returns and issue assessments.

This is not a very good system of collecting taxes, so the Legislature

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changed the law. The provision dealing with the amount of tax due with the filing of the returns is retained, but the remainder of the tax, if any, is due on November 15, if such remainder is billed on or before October 15 immediately preceding.

If the bill is dated subsequent to October 15, the tax is due within thirty days thereafter. However, if a bill is dated December 16, or later, or if no bill is received, the tax in any event must be paid by January 15.

I might say here that the tax to be paid is the balance shown on the return, which may not be the amount for which you will get a bill for later.

Since this Act of the Legislature became effective upon its enactment, it applies to 1937 franchise taxes due pursuant to returns filed this year. Heretofore, where money has been loaned to a corporation by a stockholder or a member of his immediate family, any interest paid thereon has been disallowed in determining the corporation's entire net income unless the money was borrowed to pay the ordinary expenses of the business.

This provision led to many disputes as to the reasons which prompted the loan of the money. Due to this difficulty in administration, the law has been amended to provide that there be disallowed as deduction 90 per cent of interest on indebtedness to shareholders or members of the immediate families, except that in any event $1,000 of interest may be deducted.

The purpose of the law is no longer material. While I can readily sympathize with the reasons which prompted the enactment of this provision in the first place, I feel that it should be repealed entirely because the rule is arbitrary at best and works a hardship in too many instances.

Another amendment enlarges the power of a tax commissioner in making revisions of franchise taxes. If the original tax might have been assessed on a consolidated basis but was assessed on a separate basis, the revision may be made on a consolidated basis. Also, the Commission now has the power to revise the tax of each individual corporation if the assessment was first made on the basis of a consolidation.

The Legislature has seen fit to pass an Act known as Chapter 905 of the Laws of 1937, which, it states, is not intended to change the law, but to place on the statute books the gist of court decisions as to what does not constitute doing business in this State by a foreign corporation. This enactment states that such corporation shall not be deemed to be doing business in this State for the purposes of the franchise tax, "solely by reason (a) having office furniture and fixtures in this State, or (b) the maintenance of cash balances with banks or trust companies in this state, or (c) the ownership of shares of stock or securities kept in this state if pledged as collateral security or if deposited with one or more banks or trust companies or with brokers who are members of a recognized security exchange in safekeeping or custody accounts, or (d) the taking of any action by such bank or trust company or broker which is incidental to the rendering of safekeeping or custodian service to such corporation, or (e) any combination of the foregoing activities."

Another law authorizing the Tax Commission to furnish information contained in franchise tax reports to any municipality for use in certiorari and condemnation proceedings. Certain administration changes were likewise made, but these I will not detail here, for in most instances they are technical, and to us unimportant.

In order to help balance this fiscal year's budget, a tax of two per cent on gross utilities was enacted. The term "utility" does not only apply to a corporation doing a public utility business, but to anyone, individual, partnership, corporation, and so on.

who sells telephone service, gas, electricity, et cetera, to someone else for ultimate consumption. While this tax is in effect, New York City as well as other municipalities may not levy a tax of more than one per cent on the gross income of a utility. I class this as a corporation tax because the same Bureau as administers the corporate franchise tax administers it.

I want to take this opportunity to congratulate the Corporation Tax Bureau on the admirable regulations promulgated by it in connection with the utility tax. It is my earnest hope that its experience with these regulations will lead it to issue others in connection with Articles 9 and 9-A of the tax law.

Now we come to income taxes. An amendment to the reorganization section of the personal income tax law was passed, re-defining the terms "reorganization," "a party to reorganization," and "control." So that those three definitions now agree with those contained in Section 112 of the Federal Revenue Act of 1936. These definitions apply to returns for any taxable year beginning on or after January 1, 1936.

The law now also defines the common trust fund and provides for the taxation of income of such a fund to its participants. The funds as such are not subject to taxation, nor are they to be considered as corporations. The provisions regulating to these common trust funds are quite similar to those contained in the Federal Revenue Act of 1936.

Another provision relating to the ascertainment of gain or loss was written into the law. It is provided that "in the case of property acquired by transfer and trust other than by a transfer and trust by bequest or devise after December 31, 1936, the basis shall be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss, recognized to the grantor upon such transfer under the law applicable to the year in which the transfer was made."

The Tax Commission is now permitted to require withholding agents to file returns and pay taxes withheld at any time or from time to time where collections are believed to be in jeopardy; and finally, the law was amended by striking from it the provision that salaries, wages, and other compensation received from the United States by officers or employees thereof are exempt from the income tax. This does not mean that officers and employees of the United States are subject to state income tax, but removes a statutory bar to taxation of certain individuals who receive their compensation from the federal government but are in reality the employees of a federal agency rather than of the government itself. In this connection, I cannot refrain from remarking that I hope the day is not far distant when the employees of the federal government and the state will be subject to income taxation by both jurisdictions, even as you and I.

Obligations of New York State Employers under Unemployment Insurance Laws of Other States

By Joseph Getz, C.P.A.

ONE of the questions most frequently presented to the Committee on Social Security relates to employees of New York employers, who perform their services in other States or jurisdictions either in whole or in part. The questions often refer to travelling salesmen, employees in out-of-State branches of New York firms, men sent to other States on special jobs, such as repair work, demonstrations, and to the work done for New York firms by subcontractors located in other States.

The Unemployment Insurance Law, despite the efforts of its original sponsors, is not uniform in all States or jurisdictions, and while many States have adopted Standard Laws, there are still many which are at variance in important particulars, which may be due to attempts made to suit local conditions, or perhaps local politicians. Also, despite the effort to make them part of a Federal system, these laws differ in a number of ways from Title IX, the Unemployment Insurance Section of the Federal Social Security Act. Probably one of the causes of the difference is that in some States, such as Wisconsin and New York, legislation antedated the Federal Law.

At the present time, Unemployment Insurance laws are in effect in all of the 48 States, the District of Columbia and the territories of Hawaii and Alaska, so that with the Federal, there now are 52 laws which a concern engaged in Interstate Commerce may have to take into consideration. Some examination of the Unemployment Insurance requirements of other jurisdictions must be made by the New York employer if he finds that his employees perform services elsewhere than in New York.

In considering this subject some mention should be made of the differences in the laws of other jurisdictions with regard to what constitutes "Employment," so that the New York employer may determine his obligation as to reports and contributions under such laws. Also, consideration should be given to coverage of the employee, who, to some degree, it is assumed, should be entitled, even though he does not demand it, to protection in case he becomes unemployed.

The Federal Law taxes employers of eight or more persons employed in occupations which are not specifically excluded or exempted, and permits the employer to claim as a credit an amount not exceeding 90 per cent of such tax for the taxes paid to States and other jurisdictions, or for the credits allowed by them for merit rating, etc. Should an employee of a New York employer not be covered by the New York law, for reasons which will be later discussed, from the employee's viewpoint, it would appear unjust if the employer failed to obtain coverage for him, especially if the contribution to be paid to another jurisdiction would not entail additional cost to the employer, and would not bring the total of payments to States beyond the 90 per cent credit limitation. Even if the employer is not

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liable under the particular State law, he may be able to obtain the desired coverage for the employee, because the majority of States permit a voluntary election to bring employees under their particular Act. In most jurisdictions, however, this election is coupled with an agreement by the employer to be bound thereby for a period of at least two years.

Definition of Employment—New York Law

We should consider what is meant by "Employment" under the New York law, embracing the employment upon which the employer is liable for contributions to the State, and the employee is entitled to benefits from the State in case of unemployment after January 1, 1938. In New York, the important factor in defining "Employment" is place of employment, and if an employee is employed for all or the greater part of his time in the State by an employer for at least fifteen days in any calendar year, his employment is subject to the Act. The employer, however, is not required to report and pay contributions, unless he has employed at least four persons in this State for the required period. The employer, even though employing less than the prescribed number, has the right in this State to elect to cover employees who number less than four, even one, if that is all he employs. The employer located outside of this State is subject to the New York law if he has had four persons employed within the State for the prescribed period, and all or the greater part of their work was performed in the State. He, too, even if he has a lesser number, can bring them within the scope of the New York law by voluntary election. Employees of New York employers who are employed outside of the State for all or the greater part of their time cannot be covered by the New York law, nor can the employer elect to do so. Employees outside of the State are not counted in determining whether the employer employs the four persons to be subject to the New York Act.

Residence in the State of employ, when all such employee's work is performed outside, is not a factor in determining liability, and the New York law does not distinguish between employees engaged in interstate commerce and those engaged in intra-state commerce. Also, the law makes no differentiation between residents and non-residents. Neither the location of the employer's establishment, nor the place where the contract of hire was entered into are factors in determining whether employment is to be ascribed to New York.

New York Employee Working in Several States

The tests to be applied to determine whether an employee who works in several States and it is not readily ascertainable to which State he should be reported, is subject to the New York law, are as follows:

A. If the greater part of his work is in New York State, as compared with work performed in any other State, he should be reported in New York State;

B. Where the State in which the greater part of his work is performed cannot be readily determined, he should be reported in New York, if one of the following four conditions exist:

(1) If he had a fixed place of employment in New York as designated by his employer;

(2) If the office from which his work is directed is located in New York;

(3) If the main office of the employer is in New York, or in case of employment in personal or domestic service, the domicile of the employer is New York.

(4) If the contract of hire was entered into, or the employee has his domicile within New York State.

The New York Law bases contributions on the entire wages paid to

the employee, even though the employee performs a portion of his work outside of the State, and no proration is permitted for the services performed outside of the State. Traveling salesmen, even though residents of New York and employed under a contract made in New York, who, however, perform only a minor part of their work in New York, are not covered by the New York law and cannot be covered by the voluntary election of the employer. Determination must be made in such cases of the States in which such employee works. The laws of such States must then be examined, and the State which most definitely fixes his employment as applicable to it, must be determined, and even if the employer does not meet the number of employees' requirement of that State, he may be permitted, by election, to bring the traveling salesmen within that State's jurisdiction.

Advantages of Voluntary Election by New York Employer

What advantage is there to a New York employer in causing an employee who is not subject to the New York law to be brought under the jurisdiction of another State?

1. This step may be necessary to avoid the accumulation of interest and penalties if the employer was unquestionably subject to the law of that jurisdiction, there having been the requisite number of employees employed in an "Employment" as defined by the particular State law;
2. The employee would be entitled to benefits from such State in the event he became unemployed; and in many instances, the payment of a contribution to that State would entail no additional burden on the employer, inasmuch as such payment would be included in the 90 per cent credit allowed by the Federal Act. (However, this may not be true in some cases. A New Jersey employer, subject to the Federal Act, with employees in New York State, if he elected to become a contributor to New York State, would be obliged to pay a tax of 2 per cent on the 1937 payroll of his employees in New York State and might not be entitled to a credit of more than 1.8 per cent on his Federal Tax. Another exception would be where the employer has seven employees, three of whom worked in New York State, and four in New Jersey. If such an employer elected to become a contributor, the entire tax would be an additional expense to him, as he is not subject to the Federal tax.)
3. The New York State Law authorizes the Commissioner to enter into reciprocal agreements with other States whereby the right of benefits to employees accumulated under the corresponding laws of such States may constitute the basis for payments of benefits from the New York State fund, and vice versa.

Standard Definition of Employment

In considering the liability of New York employers to other jurisdictions, mention is necessary as to how "Employment" is defined by the respective State Acts. All State laws, except ten, have a definition of "Employment" which to some degree is similar, and which may be summarized as follows:

Employment is considered as within such State if the work of the employee:

(a) Is localized within such State, when it is performed entirely within, or if both within and without such State; any service outside of the State is incidental to the services performed within such State;

(b) Is not localized to such State, but (1) if some of the services are performed within such State and the base of operations or place of control is in the State; or (2) the base of operations or place of control is not in any State in which some part of the service is performed, but the individual resides in the particular State.

In these states residence may become an important factor.

Varying Definitions of Employment

Some of the States having the above definition also include residents of their State who are employed in other States if they are not subject to the law of another

State, or if the other State has no law, provided, however, that the employer elects to bring them within the State's jurisdiction. This last mentioned provision is found in the laws of the States of Georgia, Kansas, Maine, Maryland, Massachusetts, Montana, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Tennessee, Virginia, Wyoming.

In the States of Alabama, Connecticut, the District of Columbia, Kentucky, Louisiana, and New Hampshire, the "Employment" definition has a somewhat different twist. The test is that the greater part of the employee's work is customarily performed in the State. Some of these are not concerned as to whether such employee's services under the definition of employment of another State would bring such employee within the other State's jurisdiction, but Connecticut, Kentucky and Louisiana, however, exclude services which are subject to the law of another State. New Hampshire, Kentucky and Louisiana exclude services which are performed within the State, if such services happen to be incidental to services in another State, and are subject to contributions by the employer to such other State.

Mississippi and South Carolina have definitions of employment which are also somewhat different from the Standard Laws. There, employment is defined as services rendered in the State, except where such services are incidental to services rendered elsewhere, or services which are performed elsewhere, but which are incidental to services in these States.

In the State of Vermont, a condition may arise where only a portion of the wages are taxed. "Employment" is defined as services entirely performed within the State, or if performed within and without the State and there is a base of operations or control within the State; or, if there is no base of operations or control from within the State and the services are performed within and without, contributions will be based only on the portion within the State, but the employer in such a case may elect to be taxed wholly by Vermont, or by the other State. Alabama also provides for some measure of proration in the case of employment within and without the State through the medium of reciprocal agreements with other States, which may be entered into. Hawaii, perhaps, has the broadest definition of "Employment" and considers as employment any employment, inclusive of interstate commerce performed within its jurisdiction.

Minimum Number of Employees Requirement of Other States

Satisfying the definition of employment in a particular State does not require an employer to report to such State, unless he meets the number of employees' minimum, or voluntarily elects to do so if the law of that State permits. The minimum number of employees to make the employer subject to the State law varies. In eleven States, it is one or more; in two, it is three; in seven, it is four; and in one, it is five. In all the other States, the Federal law is followed with the requirement of eight or more for twenty weeks.

States which have the standard definition of employment previously referred to, and cover an employer if he has had one or more employees in the State for a period of twenty weeks, are as follows: Arkansas, Delaware, Idaho, Michigan, Minnesota, Montana, Nevada, Wyoming. Pennsylvania, which also has a standard definition of employment, covers one or more, except that the period is three months. Other jurisdictions in which the minimum is one or more employees are Hawaii, which covers any employment within its jurisdiction for a period of twenty

weeks, and the District of Columbia, which defines employment as the greater part of services performed within the District.

Other States with standard definition of employment, which are exceptions to the eight or more employees' requirement, are Arizona and Ohio, where only three employees need be employed for twenty weeks; New Mexico, Rhode Island and Utah, four or more employees for twenty weeks; and Oregon, four or more for one day. Kentucky and New Hampshire, where employment is defined as the greater part of services rendered within the State, also have a minimum requirement of four or more employees, but for twenty days and thirteen days, respectively. The minimum in New York is four for fifteen days or more. Connecticut's minimum is five.

Voluntary Election in Other States

Voluntary election to pay contributions by an employer falls under two categories:

1. Where the employer would not ordinarily have been subject to contributions because the number of employees in the State falls below the minimum; and
2. Where the employees either are exempted or excluded by the State law.

Article IX of the Federal law does not permit employers, who are not subject to the tax because the number of employees falls below the minimum of eight, or such employees are in excluded employment, to come under its provisions. The following States, if the employees are below the prescribed minimum number, do not permit the employers to elect to come under it: California, the District of Columbia, Michigan and New Hampshire. An employer would have to have eight or more persons in California to be subject to that tax; four in New Hampshire, and only one in Michigan and the District of Columbia.

Employments Excluded—Other States

The employments which are excluded do not follow the Federal law in a number of jurisdictions, and a summary of these differences, together with the jurisdictions which permit voluntary election to be covered even though the State law excludes such employments, is next presented:

Farm Labor

The Federal law excludes Farm Labor and so does the law of every jurisdiction except the District of Columbia. Employers can elect to include them in all States except Alabama, California, Connecticut, Hawaii, Kentucky, Louisiana, Massachusetts, New Hampshire, New York, South Carolina and Vermont.

Domestic Service

The Federal law and all State laws exclude domestics, except the State of New York. Employers can elect to include them in all States except Alabama, California, Connecticut, District of Columbia, Hawaii, Kentucky, Louisiana, Massachusetts, New Hampshire, South Carolina, and Vermont.

Members of a Family

Members of a family are excluded from the Federal and most states, but are included in New Hampshire, Ohio, and Wisconsin, and may be covered in all States except Alabama, California, Connecticut, District of Columbia, Hawaii, Kentucky, Louisiana, Massachusetts, South Carolina, Vermont, and New York.

Casual Labor

Casual Labor is included in the Federal and most states but is excluded in the States of Connecticut, District of Columbia, Illinois, Indiana, Montana, Nebraska, and Oregon. However, in these States except Connecticut and the District of Columbia, casual labor may be voluntarily included in covered employment.

Crews on Ships

Crews on Ships are excluded from the Federal and most states, but are not excluded in Colorado, California, District of Columbia, New Hampshire, New York, and Wisconsin. They can be voluntarily covered in all the other States except Alabama, Connecticut, Hawaii, Kentucky, Louisiana, Massachusetts, South Carolina, and Vermont.

Employees on Relief Projects

Employees on relief projects are excluded from the Federal and all States, except Wisconsin, and can be covered in all States, except Alabama, California, Connecticut, District of Columbia, Hawaii, Kentucky, Louisiana, Massachusetts, New Hampshire, South Carolina, and Vermont.

Non-Manual Workers

Non-Manual Workers receiving over a certain amount. The Federal and State laws do not exclude such employees, except Kentucky, which excludes employees receiving $50.00 a week; New Hampshire $2,500 per annum; and New York $3,000 per annum, both manual and non-manual. These States, however, do not permit voluntary coverage of excluded employments.

Liability for Employees of Others—in Other States

Another subject which concerns New York employers in other jurisdictions is with regard to the liability for employees of others, who may be broadly classified in two groups, as:

1. Sub-agents or assistants to employees: and
2. Contractors and sub-contractors.

The law with respect to sub-agents or assistants to employees is practically standard in all but eight of the States and territories, and may be summarized as follows:

"Each individual employed to perform or assist in performing the work of an agent or employee, is deemed employed by the employer for all purposes, whether the individual was hired or paid directly by the employer or by the agent or employee, provided the employer had actual or constructive knowledge of such work."

Liability for Contractors and Sub-Contractors

With regard to contractors and sub-contractors, the treatment by the States is more varied:

A. Employers in twenty-one States and territories are liable for the employees of their contractors, sub-contractors and sub-agents, unless such contractors are themselves contributing employers. However, in all but one of these States—Minnesota—the employer is authorized to rerecover the amount of the tax from the contractors and sub-contractors. Minnesota does not give specific authority to the contributing employer to recover the tax from his contractor, although there is no provision in the Law which says that he is not authorized to do so. A summary of the Law in most States with respect to this provision follows:

"If an employer contracts with a contractor or a sub-contractor for work which is part of his usual trade, occupation, profession or business, the employer is deemed to employ all persons employed by the contractor or sub-contractor on such work, unless both the employer and the contractor or sub-contractor are otherwise subject to the Law. If a contractor or a sub-contractor is an employer otherwise subject to the Law, he alone is liable for contributions. An employer who becomes liable for and pays contributions with respect to employees of a contractor or sub-contractor who is not an employer subject to the Law, may recover the same from such contractor or sub-contractor.

The 21 States and territories which provide as above, are as follows:

Alaska	North Carolina
Colorado	Oklahoma
Delaware	Pennsylvania
Georgia	Rhode Island
Louisiana	South Carolina
Maine	South Dakota
Maryland	Tennessee
Mississippi	Texas
New Jersey	Utah
New Mexico	Virginia
Minnesota	

B. Employers of three States are liable for employees of their contractors, sub-contractors and sub-agents, but those contractors may themselves assume liability for the tax by making an agreement to that effect with the employer. These States are: Alabama, Idaho, Iowa.

C. In the States of New Hampshire and Nebraska, the employer would be liable for the employees of his contractors and sub-contractors, only if these contractors were engaged with the intention of evading the tax.

D. The Laws of New York and Illinois make the employer liable for the tax on the employees of contractors and sub-contractors if they are not classified as independent contractors performing work for others. If, however, such contractors were not performing work for others but have held themselves out as being willing to perform such work, they would be considered as independent contractors and the employer would not be liable for the tax on their employees. In Illinois, the employer may recover the tax from the contractor, but the State of New York makes no such provision. The Laws of New York and Illinois differ from the Laws of most of the other States in that if an independent contractor had less than the required number of employees, those employees would not be covered, whereas in most of the other States the employer would be required to cover the employees of the contractor, even though such contractor did not work exclusively for him.

E. Fifteen States do not in any way make the employer responsible for the employees of contractors or sub-contractors, although the employers in those States are liable for the tax on employees of their agents or assistants to employees. These States are as follows:

Arizona	Missouri
Arkansas	Montana
California	Nevada
Florida	North Dakota
Indiana	Ohio
Kansas	Oregon
Michigan	Wisconsin
Wyoming	

F. Eight States do not make the employer in any way responsible for employees of contractors, sub-contractors or agents. These States are as follows:

Connecticut	Vermont
District of Columbia	Washington
Kentucky	West Virginia
Massachusetts	Hawaii

Conclusion

The New York State employer, finding himself subject to contributions in another State or jurisdiction, either because he squarely falls within the provision of such Law, or because of his voluntary election to do so, should ascertain the type of records which it is necessary for him to keep under the particular law, and also the reports which must be filed under it. In some States the reports follow the type used under the Social Security Act, Title VIII.

The limitations of this paper do not permit a discussion of the record and report requirements of the other States. Those who are affected and are interested are referred to the Unemployment Commissions on Boards of such States for further information.

Panel Discussion on Federal Taxation

By The Committee on Federal Taxation

Chairman Klein: The meeting tonight will be divided into two parts. First of all, you are invited to sit in on a meeting of the Federal Tax Committee, and if you are sufficiently gullible, you may be willing to believe that what you witness tonight represents the ordinary sessions of the Committee. Those of you who survive that ordeal may then wait while questions are submitted to the members of the Committee and answered.

There is only one ringer here tonight. In response to the special plea made by Vice President Stempf, we have permitted him to remain with us because he is Chairman of the Institute's Committee on Federal Taxation.

I am now addressing my remarks, remember, to the members of my Committee. You are merely eavesdroppers, if you can hear me, as I hope you can.

I think that this Committee ought to discuss tonight, among other matters, the Revenue Act of 1937, and perhaps Mr. Byerly won't mind introducing that discussion for us.

Mr. Byerly: Mr. Chairman and Gentlemen: The 1937 Revenue Act was approved August 26, 1937, after long and loud publicity regarding the need of stopping the loopholes in the Federal tax laws. The Act consists entirely of amendments to the 1936 Act. Title I consists of a complete revision of Title I-A of the 1936 Act, dealing with "personal holding companies." Title II adds a new supplement, Supplement P, to Title I of the 1936 Act. This new supplement deals with a new statutory concept called "foreign personal holding companies." But not all personal holding companies that are foreign corporations are statutory "foreign personal holding companies."

Title III amplifies the previous provisions regarding items not deductible in arriving at net income. Title IV deals with trusts; Title V imposes surtaxes on non-resident aliens receiving large amounts of annual income from the United States.

Chairman Klein: Now, Mr. Byerly, you won't mind an interruption, I am sure. Do you want these hard-boiled tax men on your Committee to believe that Congress succeeded in plugging up all the loopholes?

Mr. Byerly: Far from it, Doctor. For legal or political reasons, the Act does not attempt to tax interest from state and municipal securities, nor does it attempt to deal with the split income problems in the community property states. As to the division of large personal incomes among many trusts, all the Act accomplished was to eliminate the specific exemption for each trust, and had no effect of increasing the rate of surtaxes applicable to the combined income of several trusts. Although the Secretary of the Treasury, you will recall, complained, in the preliminary discussions, of depletion which was allowed to some industries on discovery value basis and on percentage of income basis, the Act made no attempt to eliminate these well entrenched provisions of prior laws.

Chairman Klein: You just stated, Mr. Byerly, that among the important changes in the '37 Act was one

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dealing with personal holding companies. I should like to ask Mr. Ellis to tell us about those changes.

MR. ELLIS: I assume, Dr. Klein, that you refer to Sections 351 to 360 of the 1937 Act. Section 360, by the way, only provides that foreign personal holding companies shall be treated separately under a new Supplement P of Title I.

I will try to summarize as clearly and briefly as possible the principal changes which have been made by the 1937 Act. These changes will apply to the taxable years beginning after December 31, 1936; that is, of course, if the law is not repealed before it actually becomes effective.

As the allotted time is short, I will refer only to the more important changes which have been made in connection with domestic personal holding companies.

You are familiar with the surtax rates applicable to the undistributed adjusted net income of personal holding companies under the 1936 Act, rates which were in brackets ranging rom 8 per cent to 48 per cent.

The new rates under the 1937 Act are:

65% of the amount not in excess of	$2,000
75% on all in excess of............	2,000

This increase in rates is, of course, very drastic.

MR. ROLNIK: Mr. Ellis, just what is a personal holding company?

CHAIRMAN KLEIN: Do you mind answering that?

MR. ELLIS: For a corporation to come within the definition of a personal holding company under the 1936 Act, two requirements were necessary:

1. At least 80% of gross income for the taxable year should consist of certain definite kinds of income called "personal holding company income," and
2. At any time during the last half of the taxable year more than 50% in value of the outstanding capital stock should be owned directly or indirectly by not more than five individuals—with the broadened definition applied to the word "individuals."

These two conditions are practically the same in the 1937 Act, but several additional classes of income have been included in the definition of personal holding company income.

The new Act has added a further important provision, that if for any taxable year the 80% gross income requirement is present, then for each subsequent taxable year the minimum percentage shall be reduced from 80% to 70%, and so remain until a taxable year during the whole of the last half of which the 50% stock ownership requirement does not exist, or until the expiration of three consecutive taxable years in each of which less than 70% of the gross income is personal holding company income as defined.

MR. GETZ: Pardon me, Mr. Ellis. Would you at this time give a definition of income as it has been changed under the 1937 Act?

CHAIRMAN KLEIN: You mean for these personal holding companies?

MR. GETZ: Personal holding companies.

MR. ELLIS: I will be glad to do so. The kinds of income constituting personal holding company income under the 1936 Act were royalties, dividends, interest, annuities, and except in the case of dealers, gains from the sale of stock or securties.

The definition of personal holding company income under the 1937 Act includes all of these classes of income, with the following six additions:

1. Gains from future transactions in commodities.
2. Net income received by corporate beneficiaries from estates and trusts, or gains from the sale of interests therein.
3. Amounts received under contracts under which the corporation is to furnish personal services, if the indi-

vidual who performs the services owns 25% or more in value of the outstanding capital stock.

4. Amounts received as rent or compensation for the use of, or right to use property of the corporation, if 25% or more in value of the outstanding capital stock is owned by the individual having the right to use such property.
5. Other rents, unless constituting 50% or more of gross income.
6. Mineral oil and gas royalties, unless constituting 50% or more of gross income.

The 70% minimum for gross income after the first year and the inclusion of these new classes of income are, of course, intended to prevent taxpayers from creating just enough of such income for their companies so that they would not fall within the income requirement of personal holding companies.

Mr. Austin: But, Mr. Ellis, how about the stock ownership requirement?

Mr. Ellis: The stock ownership requirement for a personal holding company under the 1936 Act was that more than 50% in value of the outstanding stock should be owned by not more than five individuals, and for the purpose of determining the ownership of such stock, the shares owned by a corporation, partnership, estate or trust, would be considered as owned proportionately by its shareholders, partners or beneficiaries. It also provided that stock owned by an individual should include the shares owned by his family.

Under the 1937 Act, the 50% ownership of such stock includes not only the shares owned by an individual and members of his family, but also the shares owned by his partner. The word "family" under both Acts is defined to include brothers and sisters, spouse, ancestors and lineal descendants.

Section 354 of the 1937 Act goes much further into the matter of constructive ownership, proportionate ownership, options owned, securities convertible into stock, and other details to establish more definitely the conditions applying to effective ownership when there is not actual ownership of the stock.

Mr. Ross: Has there also been a change in the computation of adjusted net income under these provisions?

Mr. Ellis: Yes, Mr. Ross. The method of computing adjusted net income has been changed in several ways:

1. The 1937 Act imposes a 15% limitation upon the deduction for charitable contributions, while under the 1936 Act, contributions by personal holding companies were allowable in full.
2. The 1937 Act also excludes as a deduction the net losses from sales or exchanges of capital assets which are disallowed as a deduction under Section 117(d). The 1936 Act permitted the deduction of these otherwise disallowed losses.
3. Expenses and depreciation relating to the operation and maintenance of property owned by the corporation is allowed under the 1937 Act only to the extent of the rent received for the use of the property, but there are certain exceptions to this rule.

The undistributed adjusted net income as now defined also excludes the 20% credit which was allowed under Section 351(b)(2)(A) of the 1936 Act.

These, gentlemen, I think are the more important changes made by the Revenue Act of 1937 which affect domestic personal holding companies.

Chairman Klein: Thank you, Mr. Ellis.

Mr. Byerly referred not only to these domestic personal holding companies, but also to the foreign personal holding companies. With respect to those, Congress, as Mr. Byerly told us, attempted to close certain loopholes. I wonder if Mr. Getz would try to tell us how that loophole situation was met.

MR. GETZ: Yes, Dr. Klein. The principal thing which was done under the 1937 Act was to require the net income of these foreign personal holding companies to be reported by the shareholders, whether distributed or not. As to plugging the loopholes, I can only quote what Congressman Vinson said: "This type of organization must be 'asphyxiated' out of existence." The idea of taxing the income of a corporation pro rata to its stockholders, is not really anything new. We have had something like it before, in regard to the income of personal service corporations under the 1918 Act, and the same idea was used in regard to corporations unreasonably accumulating surplus, but there the stockholders had the option of including the income in their returns, or having the corporation pay a high rate of taxation; whereas here, it is mandatory that income from the foreign personal holding company be reported pro rata in the gross income of the shareholder.

According to the 1937 Act, net income, or rather what is defined as "Undistributed Supplement P Net Income," is to be included in the gross income of the foreign personal holding company shareholders, whether distributed or not, if such shareholders are citizens or residents of the United States. It applies only to those foreign corporations whose stock is owned 50% or more in point of value by five or less American citizens or residents, including members of their families. The law calls them the United States Group. It does not apply to operating companies, or companies whose stock is widely held, but to corporations which have the same type of investment income, as would make a domestic corporation subject to the personal holding company tax.

Every United States shareholder who owns 5% or more of the value of the stock in such a corporation, in addition to reporting his share of the income, must also set forth in his return, in complete detail, a statement of the gross income, deductions and credits, etc., of the foreign company for its taxable year. There is also provided a system of getting information through the requirement that disclosures be made by all persons who had anything to do with the formation of a company in some foreign jurisdiction.

The Treasury Department also is given plenty of time to get after those who fall within these provisions, by extending the Statute of Limitations with regard to income received by an American citizen or resident, to seven years instead of the three-year period for assessment which applies to regular tax returns.

MR. HORNE: Mr. Getz, I think you mentioned a term "Undistributed Supplement P Net Income." What is that, and how is it to be determined according to the new law?

MR. GETZ: Oh, that term "Undistributed Supplement P Net Income," why, that has a special meaning under this section of the law. In the case of a foreign personal holding company, the net income will be computed practically in the same manner as the net income of a domestic personal holding company, with certain exceptions which I will try to mention briefly.

First, I should mention that the gross income test has been broadened to 60%, instead of the 80% gross income test in the case of domestic personal holding companies. A foreign corporation is classified as a foreign personal holding company, if 60% or more of its gross income comes from dividends, interest, royalties, annuities, gains from sale of stocks, securities and trading in futures of commodities. In the gross income test (of what is to be included in the 60%), is also included rents, unless the rents constitute 50% or more of the gross income, thus eliminating bona fide real estate operat-

ing companies. Other items of income are also to be included in the gross income test, such as income from property used by a stockholder, covering incorporated country homes, estates and yachts, and income from incorporated talents of a stockholder.

The undistributed adjusted net income is determined in the same manner as the undistributed adjusted net income for a domestic personal holding company; from the undistributed adjusted net income, dividends paid are deductible, but the dividend carry-over provisions do not apply to either foreign or domestic personal holding companies. Taxes which are paid by a foreign corporation to some foreign country are not allowed as a credit, but may be merely taken as a deduction from income. A deduction is permitted for charitable contributions, subject to the 15% limitation, instead of the unlimited deduction permitted to personal holding companies heretofore. No deductions are allowed for taxes paid by the corporation for the benefit of the shareholder, or for payments made by the corporation to a pension trust, which domestic personal holding companies are permitted.

The deductions for expenses and depreciation are limited to an amount equal to the rent or other compensation received for the use or right to use property, unless the taxpayer can establish that the rent or other compensation received was the highest obtainable, or if none was received, that none was obtainable. Or, on the other hand, that the property was held in the course of a business carried on bona fide for profit, and that there was a reasonable expectation that the operation of the property would result in a profit, or the property was necessary in the conduct of the business. This, of course, would allow ordinary office expenses and depreciation of office furniture and fixtures, but would prevent any allowances of deductions for maintenance of country homes, yachts and similar property.

MR. COOPER: Mr. Getz, aside from those income differences, are there any differences in the ownership tests between foreign and domestic companies?

MR. GETZ: No, Mr. Cooper. The ownership tests are practically similar to those provided for domestic personal holding corporations, and I believe Mr. Ellis has very well covered that particular point. If five or less persons who are citizens or residents of the United States own more than 50% of the stock, the corporation meets the gross income test, and the corporation comes within the provisions of Supplement P of the 1937 Act, then each United States stockholder must include his pro rata share of the undistributed income as a dividend in his return.

I may mention that changes in the ownership test have been made by the 1937 Act, so that it also covers convertible securities into stock of the corporation, options to acquire the stock, and the partner of one of the five, so as to bring the total to the least number of persons.

MR. SALVATORE: Mr. Getz, it seems to me that if a taxpayer is a shareholder in one of these corporations, all that he has to do is report his share of the distributed income, and when he has held it long enough, he liquidates or sells or disposes of his stock, and the profit would be included at 30% or 40% under the capital gains provisions. Is that so?

MR. GETZ: No, it would not work out like that, Mr. Salvatore, unless a liquidation took place before January 1, 1938, and if the period of investment by then brought the transaction into the lower percentage brackets under Section 117-a. After January 1, 1938, 100% of the liquidating gain will be taxable, un-

less the taxpayer makes an application for an extension on the grounds that the laws of the foreign country in which the corporation was organized do not permit liquidation by January 1, 1938, when the Commissioner may extend the right to the benefits of this provision until June 30, 1938. If he sold his stock, providing he could find a buyer, I guess he could get the benefit of Section 117. On the other hand, take the case where the taxpayer says: "I'll wait until I die, then my estate won't have to pay on anything but the value of my stock in the foreign corporation at my death." He would find, providing, of course, he can view things from where he is, either above or below, that there is something else to it. The stock of the foreign personal holding corporation will be taxed in his estate at the fair market value of the property at the time of death, but for loss or gain purposes on subsequent sale, the basis will be the cost to the decedent during his lifetime, or the value at the time of acquisition by the estate, its heirs or next of kin, whichever is lower — another case of double taxation.

CHAIRMAN KLEIN: I think, Mr. Getz, you have more than answered the question, and, Mr. Byerly, may I say that your brief remarks seemed to have furnished texts for long, long speeches.

You referred to this loophole tax as consisting of several titles. Title III ought to be an interesting subject for discussion. I am wondering whether Mr. Cooper would care to tell us how under this Act certain accrued expenses are treated.

MR. COOPER: Yes, Mr. Interlocutor. (Laughter)

CHAIRMAN KLEIN: If there are any more interruptions from this audience, we will ask Mr. Cooper to leave. (Laughter)

MR. COOPER: Well, we have to have a little fun out of taxes, anyway.

Taxpayers reporting on an accrual basis may no longer deduct accrued ordinary and necessary expenses and interest when the three following circumstances are present: Before I mention them, let me bring out that ordinary and necessary expenses include compensation for personal services. I wasn't sure of that, and I had to look it up again.

Here are the circumstances: First, when the items in question are not actually paid in cash or other property, within the taxable year or within two and one-half months after its close; second, if the method of accounting of the person to whom the payment is to be made is such that the amount of the expense or interest would not, unless paid, be included in his gross income for the taxable year in which or with which the taxable year of the taxpayer ends. That is another way, of course, of stating recipient on the cash basis. Third, if at the close of the taxpayer's taxable year or at any time within two and one-half months thereafter, both the taxpayer and the person to whom the payment is to be made are persons between whom losses on sales or exchanges would be disallowed.

MR. STEMPF: Mr. Cooper, who are persons between whom such losses are disallowed?

MR. COOPER: That goes back, of course, to the '36 Act as it was amended. The losses with respect to sales and exchanges of property are not allowable if resulting directly or indirectly under the following circumstances. There are six:

1. Between members of a family, as, for instance, brothers and sisters, a spouse, ancestors, or lineal descendants.
2. Except in the cases of liquidation, losses on transactions between an individual and a corporation, more than 50% in value of the outstanding stock of which is owned directly or indi-

rectly by or for such individual. Notice those words, "by or for."

3. Again except in the cases of liquidation, between two corporations more than 50% in value of the outstanding stock of each of which is owned by or for the same individual, if either one of such corporations was, for the taxable year preceding the date of the sale or exchange, a personal holding company or a foreign personal holding company.
4. Losses are not allowable when incurred in transactions between a grantor and the fiduciary of a trust of which he is the grantor.
5. Losses are not allowable between a fiduciary of one trust and a fiduciary of another trust if the same person were a grantor with respect to each trust.
6. Losses are not allowable when incurred in transactions between a fiduciary of a trust and beneficiary thereof.

Note particularly that these limitations apply to transactions "directly and indirectly" occurring under those circumstances and involve ownership "by and for" an individual. There are a number of special provisions relating to those matters that we could spend all night talking about, but I think it is just as well not to prolong it and make it too long, Dr. Klein, so I will pass those up and not go into them in detail.

MR. BYERLY: Mr. Cooper, we agree with you that those would be rather too long for this meeting. I want to ask a question. A while ago you mentioned three conditions under which these deductions were disallowed. Does that mean they are disallowed if any one of those three conditions exists?

MR. COOPER: All three of those conditions must be present. If you have only two present, you have no limitation on your deductions in that respect.

MR. ELLIS: Mr. Cooper, would these provisions apply in the case of a taxpayer whose fiscal year ends on November 30, 1937?

MR. COOPER: No. Congress has followed its usual practice of making these new laws applicable to fiscal years or taxable years beginning on or after January 1, 1936. Hence, a fiscal year ended November 30, and that means a full twelve months' period, would have begun December 1, 1936, and so it would not apply.

MR. STEMPF: Dr. Klein, I should like very much to hear you discuss this question of disclosures by accountants.

CHAIRMAN KLEIN: Let me offer a few observations.

T.D. 4773, interpreting Section 340 and the return, Form 959, became available a few days ago. In the main, they are easy to understand. First may be mentioned the two classifications for which returns are required: (1) Advice or aid given between January 1, 1934, and November 24, 1937, where returns are due, *if and only if,* the formation, organization or reorganization of a foreign corporation was *completed* by November 24, 1937; (2) current advice, etc., since August 26, 1937, with respect to which returns are required regardless of the status of completion. All of us have probably noted the ambiguity relating to returns if the giving of advice occurred between August 26 and November 24 of this year, but I shall not at this moment try to reduce that ambiguity to positive interpretation.

MR. ROLNIK: What do you suggest, Doctor, we do about this?

CHAIRMAN KLEIN: Well, speaking for myself alone, I would say: take no chance. I would resolve the doubt against myself. I would file returns if advice regarding foreign corporations had been given between August 26 and November 24, of this year, even if the reorganization, etc., has not been completed, and, indeed, even if the project had been abandoned entirely.

MR. GETZ: Dr. Klein, should the first returns be filed on November 24?

CHAIRMAN KLEIN: Yes, I think so, for both classifications, although the T.D. is not clear on this point. Thereafter, 30-day returns, as you know, are required for each case during its pendency.

MR. AUSTIN: Mr. Chairman, many people are wondering whether any useful purpose is really served by these onerous and inquisitorial requirements. What do you think?

CHAIRMAN KLEIN: Well, without wishing even to appear to approve the requirement, I believe that I may say that the manifest purpose is to discourage questionable practices indulged in by an insignificant minority, and that the means chosen may very probably prove effective.

MR. ROSS: Mr. Chairman, the law requires you to report advice given in connection with reorganizations of foreign corporations. I find no definition of reorganizations in the new law. Do you?

CHAIRMAN KLEIN: No, I find no such definition. In my opinion, the term is used in its ordinary sense and not as defined in Section 112(g)(1) of the 1936 Act, which expressly relates only to Sections 112 and 113 of that Act. Nevertheless, Congress may have intended to have Section 112(g)(1) apply, and the statutory definition may later be extended. At any rate, for myself, I would report advice given in connection with reorganizations of foreign corporations, allowing the term its widest connotation.

MR. HORNE: Dr. Klein, would you include statutory liquidations among reorganizations?

CHAIRMAN KLEIN: Please lower your voice and stop frowning when you address your friend and chairman, Mr. Horne. (Laughter)

No. Even the 1936 statute does not do so. Nevertheless, some liquidations may be so closely akin to reorganizations, in the ordinary sense, that advice given with respect to such transactions had better be reported. May I not add that accountants (and I hope no one here will take offense) should not be as technical, say, as some technical lawyers, the proverbial Philadelphia variety, for example.

MR. COOPER: Dr. Klein, as long as lawyers get certain exemptions from reports on the ground of confidential relationship, can't the client prevent the accountant from making those disclosures?

CHAIRMAN KLEIN: Let me answer your question this way: The accountant should inform the client or the client's attorney, or both, of the proposed disclosure return. The only remedy available to the client which suggests itself to me at the moment is the statutory injunction. In such a proceeding, the Government would be entitled to be heard, I believe. I am not prepared, however, to pursue the thought any further at the moment.

MR. SALVATORE: Just one question, Dr. Klein. Won't Section 340 tend to drive foreign reorganization engagements away from us and to lawyers who enjoy the benefit of privileged communications?

CHAIRMAN KLEIN: I know that you are not personally worrying about that, Mr. Salvatore. I suppose that is so, although it remains to be seen just what the privilege granted to attorneys really amounts to. Perhaps the type of work you have in mind will go to foreign attorneys and foreign accountants who do not have to make any disclosures at all.

MR. BYERLY: If the present disclosure requirement is found to be lawful, Dr. Klein, is it not probable that the provision will be extended

to cover tax advice given generally, and not only in connection with foreign corporations?

CHAIRMAN KLEIN: Possibly, but let me refrain from indulging in prophecy tonight.

MR. ELLIS: Now, Dr. Klein, only one more question—

CHAIRMAN KLEIN: Not now, excuse me, Mr. Ellis. We have already spent more time than was planned on the subject of disclosures. I suggest that you hold your query until the question hour.

MR. ELLIS: Very well.

CHAIRMAN KLEIN: I suppose that we ought to say a word in this committee meeting about capital gains. The newspapers are full of what Congress will or will not do about that subject. What are your thoughts on capital gains, Mr. Ross?

MR. ROSS: I have a feeling that Congress has suffered a change of heart and will finally do something about reducing taxes on capital gains.

Taxpayers have complained bitterly ever since the 1934 Act took away the benefit of a low maximum rate of 12½ per cent on capital gains, and limited capital loss deductions. But it was not until the recent stock slump, however, that the authorities showed any real concern. Then they became aware that security-owners (at least those in high brackets) had become "profit-shy" and were shrinking from the impact of the high tax rates, and that the discouraged sales had permitted stock prices to soar, that the normal price corrective that profit-taking would introduce had not been forthcoming.

Also, you must give the Treasury and Congress credit for some common sense. More transactions, greater turnover even at lower tax rates will produce more revenue, a conclusion borne out by the experience in 1921, when the 12½ per cent flat rate was introduced.

MR. ROLNIK: Mr. Ross, many contend that capital gains do not represent true income to the usual investor, and that no tax should be imposed on such gains at all. I gather that you don't think there is any chance that Congress will exempt them entirely.

MR. ROSS: There is no chance that I see that the British example, for instance, of ignoring capital gains, except to dealers and traders, will be followed, for even though it may be shown that in some special cases they do not represent true "income," yet generally there persists, I believe, the conviction even among economists that such gains carry some "ability to pay" and should be required to contribute to the revenues.

MR. GETZ: Mr. Ross, if Congress reduces rates on capital gains, wouldn't it also be obliged to reduce rates on other income, particularly in the higher brackets?

MR. ROSS: No, I don't think so, because as distinguished from "other income," realization of "capital gains" is initiated by the taxpayer himself. There is no recognized acceptable way in which the Government can compel the taking of profits, so any new tax proposals must be framed so as to induce profit-taking, not to discourage it.

The only suggestion that may be said to dodge this problem comes from the 20th Century Fund, a suggestion which proposes that capital gains be measured by annual increase in market values and that they be taxed at regular rates. But the report itself recognizes that this would probably require a constitutional amendment and that at best it is beset by insuperable administrative difficulties.

MR. AUSTIN: But apparently the 20th Century Fund plan has made no headway, for I see by the papers that Mr. Vinson, of the Ways and

Means Sub-committee, has announced an entirely different scheme. I suppose you read the newspapers. Can you tell us something about this?

MR. ROSS: I did see the newspaper account, but it wasn't very detailed. I am not sure I got all the essential elements, but so far as one can tell, the Vinson plan is a double-barrelled scheme. First, in modified form, it applies the present principal of taxation of "capital gains," in diminishing percentages as ordinary income at full rates. Second, it offers an optional alternative of taxing the entire capital gain without regard to "other income" at graduated rates varying with holding period, the taxpayer having the choice each year to adopt the more favorable alternative.

MR. HORNE: Mr. Ross, you say that one of the alternatives under the Vinson plan incorporates the features of the present Act, but it does depart from the present Act in some regard, doesn't it?

MR. ROSS: Yes, it does. Under the present law, the percentage of recognized gain drops sharply at long intervals, one year, three years and five years, with the rate fixed at 30% after ten years. The Vinson proposal provides easier stages. One-year transactions, as at present, are taxed in full; but beginning with the second year, and for that year only, the percentage of gain recognized drops 2% a month, so that only 76% of gain on an asset held exactly two years is taxable.

From the end of the second year, and for the three succeeding years the percentage recognized is dropped 1% a month, the rate then becoming 40%, at which it remains. Under the present law, the lowest percentage of gain recognized is reached after ten years (30%); under the Vinson proposal the lowest rate (40%) is reached after five years, shortening the period for which it may pay to withhold sale for tax reasons by five years. The intention here, of course, is to accelerate transactions, but it does seem that the gradual reduction of 1% a month for three years until 40% is reached will cause some to hold on until the maximum benefits can be obtained, thus defeating that purpose. But, on the other hand, many will not risk price changes for the sake of 1% a month.

MR. COOPER: Mr. Ross, even for those in the highest bracket, however, with 76% or even 64% of the gain recognized after three years, won't the rate be so high as to be prohibitive?

MR. ROSS: Well, some sales may be deterred, it is true, but in the very, very high income groups the optional alternative which fixes the maximum at 30% of the entire capital gain, after the first year of holding, will no doubt be more attractive and perhaps not prohibitive. This rate is reduced for each year of holding till the lowest rate of about 16% is reached after five years. Here, too, the temptation to hold on to get the best rate may deter earlier sales, but that element is inherent in any scheme that wishes to recognize holding periods, by, in effect, spreading the appreciation or depreciation more evenly over time.

MR. SALVATORE: Did it appear from the newspaper account what the Vinson plan contemplates with respect to capital losses in excess of capital gains?

MR. ROSS: The Vinson scheme apparently does not permit the application of capital losses against ordinary income, but it does provide a carry-over for one year of capital losses against capital gains of the succeeding year.

MR. STEMPF: Much of the public furore relates to the rates of capital gain tax. Even if the revenue bill becomes satisfactory on that score,

are there not other features of the present capital gain provisions which require change?

Mr. Ross: There are many other features, but I shall limit myself here to the two outstanding ones referred to in the excellent report of the American Institute Committee on Federal Taxation.

Chairman Klein: You mean Mr. Stempf's report.

Mr. Ross: Yes. (Laughter) Under the present law, a partnership is treated as a taxable entity and its capital net losses are subject to a $2,000 limitation. Partnership capital losses in excess of $2,000 may not be applied by the partners in reduction of their individual capital gains; nor may an individual partner's capital losses be offset against his share of partnership capital gains before applying the loss limitation. Assuming that there must be a loss limitation, it is only fair that it be applied only after an individual has gathered together his realized gains and losses from all sources, for, after all, a partnership is just a federation of individuals and not a distinct entity, like a corporation.

The second feature I wish to refer to concerns corporations. Corporations, too, are limited to a $2,000 capital loss limitation, and since all assets but stock in trade are regarded as "capital assets," the deduction for loss on the sale of land, buildings or machinery is restricted, with even more serious results from the standpoint of the Undistributed Profits Tax.

Whatever the proper treatment on the sale of company investments (and here, too, some recognition of holding period should be given), surely such business assets as buildings, etc., should be given full status. The present treatment becomes especially anomalous when we remember that as a machine, for instance, is consumed in use, the entire cost may be gradually deducted from income as depreciation. But let the owner dispose of this machine before cost has been recovered through depreciation charges, the otherwise ordinary loss of the unexpired cost is converted to a capital loss. It is inconsistent not to treat the loss on the sale of this machine as merely completing the annual depreciation charges as deductible in full.

Chairman Klein: I am going to ask the President — our President, the Society's President—to give me members on this committee who don't seem to know so much about the subject; they talk too long.

I am going to ask Mr. Horne now to tell us, if he can, just what is a tax-free stock dividend. That ought to be an easy one for him.

Mr. Horne: I think probably he cannot tell you. Until May 18th of last year, all of us were confident that we could answer that question correctly. We are not so sure since the Supreme Court in the *Koshland v. Helvering* decision showed us that both the Congress and the Treasury Department had gone much further than had been required by the stock dividend decisions in *Towne v. Eisner* and in *Eisner v. Macomber.*

Mr. Byerly: That is so, but can we not say which type of stock dividend is entirely tax-free, which is surely taxable, and which is in a twilight zone of doubt?

Mr. Horne: A true stock dividend is undoubtedly tax-free. Common examples are "split-ups" and the issuance of additional common stock where, prior thereto, only common stock was outstanding. The Supreme Court's decision in the Koshland case was that a distribution of common stock to preferred stockholders was not a true stock dividend because that distribution resulted in changing the proportional interests of the stockholders in the equity value of the corporation. The court said that the distribution in

that case was income to the stockholders who received it and that such income was taxable under the constitution.

At the present time there are two other cases before the Supreme Court, on writ of certiorari, in which the question is the taxability of preferred stock which was issued to common stockholders. Those cases are *Gowran v. Commissioner* (7th Circuit) and *Pfeiffer v. Commissioner* (2nd Circuit).

MR. ELLIS: Mr. Horne, aside from the decisions still to come in those cases, I think there is still something more to be said about stock dividends.

MR. GETZ: Yes, there is, Mr. Horne. Tell us what Congress did about the Koshland decision.

MR. HORNE: It carefully steered a course right down the middle of the road. You will remember that, ever since the 1921 Revenue Act, stock dividends have been expressly made not subject to tax. The change made by the 1936 Act, in Section 115(f) is that the only distributions of stock which are tax-free are those which do "not constitute income to the shareholder within the meaning of the Sixteenth Amendment."

CHAIRMAN KLEIN: You have done so well, Mr. Horne, thus far, I think you have pretty well covered the subject. I am going to ask you to sum up. (Laughter)

MR. HORNE: True stock dividends, including "split-ups" continue to be free from income tax. Distributions of preferred stock to common stockholders, where prior thereto only common stock was outstanding, probably are also tax-free though no definite ruling has yet been made. Possibly all other types of stock dividends are now taxable.

It is probable that up to and including 1935, because of express statutory provisions, all kinds of stock dividends were tax-free.

Notwithstanding this, it seems to be clear that the basis of the old stock with respect to which the tax-free stock dividends had been received, is not to be apportioned between the old stock and the new stock, except in the case of such true stock dividends as are not taxable under the 1936 Act.

CHAIRMAN KLEIN: You won't take it amiss, I hope, Mr. Horne, if I suggest that whatever you said; and what was said before you spoke, by all of us, including myself; and perhaps what will be said later by the other members of the committee; is to be handed out (because I understand some people are listening in) with this grain of salt, namely, that these are opinions, that they are not guaranteed, but that we hope that some of what was said—happens to be correct.

MR. HORNE: I will not only not take it amiss, but I shall say "Amen" to it.

CHAIRMAN KLEIN: Let's leave that subject and go to the undistributed profits tax.

I am going to ask Mr. Salvatore, what is the present situation in regard to the undistributed profits tax?

MR. SALVATORE: At the present time considerable pressure is being brought to bear on Congress for revision of the tax. The National Association of Manufacturers, the U. S. Chamber of Commerce, the American Bar Association, the American Institute of Accountants, the New York State Society and similar organizations are practically unanimous in their proposals to revise the law. The daily papers are full of statements by many business and political leaders as to what revisions should take place. In his message to Congress last Monday, the President himself stated that unjust provisions in the law should be removed.

MR. ROLNIK: Are many changes in the law proposed?

MR. SALVATORE: Yes, the proposals run from outright repeal of the surtax to mild modifications of its more "unfair" provisions.

MR. AUSTIN: Can you give a brief summary of the more important proposals for revision?

MR. SALVATORE: There are at least eight important proposals which should be given consideration when the law is redrafted: (1) to levy the tax on undistributed business profits and not on undistributed statutory income; (2) to exempt a portion of earnings for that "rainy day"; (3) to grant relief to debt-ridden corporations; (4) to exempt amounts used for expansion or modernization of plant and equipment; (5) to recognize State laws restricting payment of dividends; (6) to allow credit for dividends paid shortly after the end of the taxable year; (7) to permit a net loss carry-over and (8) to allow corporations sixty to ninety days to pay out in dividends any increase in income finally determined by the Treasury Department.

MR. ROSS: You said that the surtax should be levied on undistributed business profits rather than on undistributed statutory income. Why is this of such importance?

MR. SALVATORE: Well, under the present income tax law, there is a great difference between statutory net income and business net income, due to the disallowance for tax purposes of certain regular business losses and expenses. For instance, a corporation might have net profits from operations of $50,000.00, and capital net losses of $50,000.00; its net business income would be nil, but its statutory net income would be $48,000.00, and if it were unable to make a dividend distribution, it would be liable to a surtax of some $8,500.00. Moreover, in the example just given, if the corporation had a deficit at the beginning of the year, even though it were to make a distribution to the full extent of its statutory adjusted net income, it would get no dividends-paid credit and consequently would still be liable for the surtax of $8,500.00.

MR. HORNE: You mean to say that even though the corporation makes a distribution to the full extent of its statutory adjusted net income it would still be liable to the surtax? How can that be?

MR. SALVATORE: This situation is possible because under the law a corporation (not in liquidation) secures a dividends-paid credit only if the distribution is a taxable dividend, and under Section 115(a) a distribution is not a taxable dividend unless it is out of "earnings or profits". In the example just given, the corporation had no "earnings or profits" and, consequently, could not obtain a dividends-paid credit.

MR. COOPER: What do you mean by the proposal that recognition should be given State laws restricting payment of dividends?

MR. SALVATORE: The corporate laws of most States permit the payment of dividends only out of the excess of assets over liabilities and capital stock (in other words, out of surplus). Therefore, corporations organized under the laws of such States, and which have adjusted net income during the taxable year and a deficit at the end of the year, cannot avoid the tax without violating the State law. Section 26(c)(1), which allows a credit for earnings which cannot be distributed, should, therefore, be amended so as to recognize corporate charters as written contracts.

MR. STEMPF: Does the law at the present time hold that the charter of a corporation is not a written contract within the meaning of Section 26(c)(1)?

MR. SALVATORE: No, but the Commissioner of Internal Revenue has

categorically ruled that the charter of a corporation does not constitute a written contract executed by the corporation within the meaning of the statutory provision just mentioned. Whether or not the Commissioner is correct is an unsettled question. However, Congress could avoid needless litigation on this point by giving recognition to State laws restricting payment of dividends.

MR. BYERLY: How about corporations organized under State laws which do not restrict the payment of dividends? Should such corporations be required to pay dividends where they have a deficit?

MR. SALVATORE: No; it is against sound financial policy to pay out dividends where a deficit exists even though the State law permits such a procedure. Furthermore, under the law, a corporation obtains a dividends-paid credit only if the distribution is a taxable dividend, and it is an unsettled question as to whether any dividend paid by a corporation with a deficit is taxable.

MR. ELLIS: Is there any particular proposal which would have the immediate effect of improving the present business situation?

MR. SALVATORE: At the present time the administration is calling upon industry to absorb the unemployed by planning construction and expansion of plant facilities. Under the income tax law, however, all corporations, large or small, must pay the surtax penalty even though the profits are withheld for plant expansion. It is generally thought that a revision of the law permitting an exemption from the surtax of amounts used for expansion and modernization of plant and equipment, would go a long way toward stimulating construction with its attendant alleviation of unemployment.

MR. ROLNIK: Must all the proposals be effected to ease the situation? Isn't there a more direct way of revising the surtax so as to eliminate the majority of the "unfair" provisions?

MR. SALVATORE: There is belief in many quarters that a general exemption—such as a percentage of earnings or a flat minimum amount—would relieve the situation and make most other changes unnecessary. In fact, it was reported last Tuesday that the House Ways and Means tax sub-committee agreed to exempt from the surtax all corporations having net incomes of $5,000.00 or less. It was also indicated that a formula for a percentage graduation of exemptions might be worked out for corporations with net incomes ranging from $5,000.00 to $50,000.00. At any rate, a substantial general exemption from the surtax for all corporations would permit the building up of reasonable reserves for working capital and future development. It would encourage the legitimate accumulation of corporate surpluses necessary to maintain dividends, wages, employment, and business solvency through periods of depression.

MR. GETZ: Although the proposals appear sound, will they not have the effect of reducing tax revenue?

MR. SALVATORE: On the contrary; it is generally felt among responsible business leaders that adjustment of these basic inequities will remove obstacles from the path of business and that the consequent increase in business volume will greatly add to the tax revenue. Moreover, serious attempt should first be made to curtail government expenditures; and if additional revenue is then required, it would be better to increase corporate tax rates rather than keep the present surtax inequities in the law.

CHAIRMAN KLEIN: Thank you Mr. Salvatore. Suppose we go to the sub-

ject of statutory reorganizations. Those of us who have wrestled with the problem have been constantly impressed by the distinction between reorganizations as defined by the Revenue Act, and the ordinary or legal concept of the term.

I am going to ask Mr. Austin to tell us something about the origin and development of the statutory concept.

MR. AUSTIN: The statutory reorganization provisions owe their existence primarily to the Supreme Court's harsh and highly technical rulings in the *Phellis, Rockefeller, Cullinan* and *Marr* cases, as the result of which practically all reorganization exchanges became taxable, barring Congressional intervention. The first reorganization provisions appeared in the Revenue Act of 1918, but without definition of the term "reorganization" itself, this being left to the courts. We have come a long way since then. In 1921, the term was expanded to embrace mergers and consolidations, including the parenthetical modifying clause, which has since caused so much trouble.

In 1924, the definition was made exclusive, and at the same time there were included within its scope transactions involving the splitting-up, or proliferation, of existing corporations. The 1924 definition remained unchanged for ten years, when Congress felt compelled to change it, and at the same time eliminate the provision for tax-free distributions of securities, by reason of the prevalence of the type of transaction involved in the *Gregory* case, and the long line of conflicting decisions regarding the meaning of the modifying parenthesis, in the part of the definition dealing with mergers and consolidations, which finally culminated in the Supreme Court decisions in the *Minnesota Tea Co.* and related cases. The definition adopted in 1934 is still in force.

MR. ROSS: Mr. Austin, what is the present statutory definition of reorganization?

MR. AUSTIN: The present definition provides for four classes of transactions: (1) transactions having the effect of mergers or consolidations, if effected under local merger or consolidation statutes, or through the acquisition by one corporation, solely in exchange for all or a part of its voting stock, of substantially all of the property of another corporation, or of such portion of the stock of another corporation as represents at least 80% of the combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock; (2) transactions involving the transfer of assets by one corporation to another, if immediately after the transfer statutory control of the transferee corporation is vested in the transferor corporation or its stockholders, or both; (3) recapitalizations; and (4) mere changes in form, identity and domicile.

MR. HORNE: Mr. Ross just commented to me, Mr. Austin, that he supposed that probably all that is in the statute. But are we safe once we literally comply with the statute, or are there further considerations?

MR. AUSTIN: There are further considerations. Until the Supreme Court's decision in *Gregory v. Helvering,* it was commonly believed that compliance with the letter of the statute was sufficient to insure non-recognition of gain or loss. This is no longer the law. As was said in a very recent decision on this subject, to understand this statute we need more than a dictionary. Not that literal compliance with the statute is no longer required; it still is, and is most essential. But something more is necessary.

While the precise scope and meaning of *Gregory v. Helvering* may not be

authoritatively defined for many years, it seems clear, at least, that in order for a transaction to be within the statute, it must not only comply literally with the definition, but must be in pursuance of a plan, the result and object of which is a real corporate reorganization of a corporate business or businesses, as distinguished from a corporation, the sole reason for the existence of which is tax avoidance; it must not be a transaction masquerading as a reorganization under the letter of the law, but actually accomplishing an ulterior object totally foreign to the statutory concept of reorganization. The clearest application of this rule has been to render futile the use of temporary corporations, which live for a day and die, existing merely for the purpose of lending the form of statutory reorganization to transactions totally different in nature. Despite the oft-repeated statement that a tax avoidance purpose does not *per se* vitiate or condemn a transaction, or its effectiveness, the effect of the existence of such a motive still remains doubtful in reorganization cases, because of the judicial statement in *Gregory v. Helvering* regarding the necessity of germaneness to a corporate business purpose, and especially in view of the avowed attitude of many courts, where such a purpose appears, to do everything within their power to defeat such purpose, or, at least, to go no further than the law compels, to support such a transaction.

CHAIRMAN KLEIN: Our discussions have already taken so long and Mr. Austin has answered the questions already put at such great length, that I would like to see if some member of the Committee can ask a question of Mr. Austin which really can be answered briefly.

MR. COOPER: If anybody can do that on reorganizations, he is good, so I'll go to it. What are some of the more important unsettled questions affecting the tax status of reorganizations? (Laughter)

MR. AUSTIN: I shall succeed in making the answer very brief by leaving out most of the unsettled questions.

I think that the extent of the applicability of *Gregory v. Helvering* is about the most important unsettled question, but apart from that, we may refer first to the question of whether the assumption of liabilities in reorganization transactions constitutes the giving of taxable "boot." If it does, not only are many exchanges made taxable to a limited extent, but under the present statutory, definition, which, in some cases, requires that an exchange be solely for voting stock, the assumption of liabilities will prevent many transactions of the merger or consolidation type from even qualifying as statutory reorganizations. There is at present a conflict of authority on this point, the latest decision being that in the Fourth Circuit in the *Hendler* case, which held that assumption of liabilities was not "boot."

Another unsettled question is whether the statutory non-recognition provisions and the related basis provisions are to be taken into account in determining corporate earnings or profits available for dividends, as distinguished from statutory net income. The Regulations hold that they should be; the Tenth Circuit early in 1937, in the *McKinney* case, held to the contrary, and the Board of Tax Appeals, in several cases handed down in 1937 has likewise held to the contrary.

Whether for the purpose of determining the Supplement P net income of a foreign personal holding company, such a company can be a party to a statutory reorganization without prior consent of the Commissioner in view of the statute providing that Supplement P gross income shall be determined as if the

foreign personal holding company was a domestic corporation, is one of our newest questions, to which I have no answer.

The Supreme Court, in the *Groman* case, decided only two weeks ago, disposed of an unsettled question by holding that the term "party to a reorganization" included only those corporations which were direct participants in the transaction which met the statutory definition, and did not include a corporation not participating directly and immediately in that transaction, even though such corporation was the parent of one of the participants, and was the instigator and mainspring of the transaction, which would not have been possible without its intervention and the furnishing by it of necessary stock and securities.

CHAIRMAN KLEIN: So, gentlemen of the Committee, you see that if we have some doubt as to what is really a true stock dividend, we also may well have doubt as to what is a statutory reorganization, but we can't linger on that.

We will go to the last topic on our list. It deals with losses in connection with worthless securities. I shall ask Mr. Rolnik to discuss that and the related subject, specifically perhaps, what are some of the conditions limiting losses on worthless securities.

MR. ROLNIK: As we all know, the income tax law imposes one invariable condition on taxpayers wherever any loss—in fact any kind of deduction—is claimed: The taxpayer has to prove it. Some of the conditions laid down by the law or the regulations are purely arbitrary, as the one permitting a partially worthless bond as a deduction, but not a partially worthless stock. Again there is the condition in the case of a worthless bond that the amount claimed for any year must be charged off on the taxpayer's accounts in that year.

In view of the limitations on capital losses and on losses in exchanges and reorganizations, the taxpayer who holds bonds is in a little better position than the one who holds stock. The bondholder may often claim a partial bad debt, even though he later sells the bond or in a subsequent year gets some new securities in a reorganized company. Of course, to get an allowance for a partial bad debt, he will have to convince the Commissioner what the ultimate recovery is likely to be, and this is a very difficult thing unless the Commissioner's office is most sympathetic.

MR. AUSTIN: Mr. Rolnik, won't you tell us something about capital losses in this connection?

CHAIRMAN KLEIN: Mr. Rolnik, while you are trying to think up the answer to that, may I remind the audience that if there are questions to be submitted and they haven't already been written, will they please write them now? No offense will be taken by any member of the Committee if the questions this time, for a change, are really legible. (Laughter)

MR. ROLNIK: This question of capital losses is allied to the subject of losses on worthless securities because, as we will recall, capital losses apply not only to sales but to exchanges as well. In the case of mortgage foreclosures, this raises an interesting question: Is the loss to the holder of the mortgage an ordinary loss, that is a bad debt, or is it a capital loss and thus subject to the limitations on capital losses? We have recently had a ruling, I. T. 3121, in which the Commissioner holds that where the mortgage holder bids in the property for a price equal to the cost of his mortgage, he hasn't any "bad debt" de-

duction. For example, if he owns a mortgage which cost him $1,000, and he bids in the property under foreclosure for the same amount, he has no "bad debt" deduction. On the other hand, if he bids in the property for $900 and it will be impossible for him to collect the $100 deficiency from the debtor, he has a bad debt of $100.

This is simple so far. But the I. T. goes on further. Suppose the mortgage holder bids in the property for $900, as I just said, but the property is worth only $700. As the mortgage cost him $1,000, and the property is worth $700, he really has, from a bookkeeping point of view, a loss of $300. But the I. T. doesn't permit the full $300 as an ordinary deduction. You will recall, the bid price of the property was $900, but it had a value of only $700. The ruling implies that the $100 difference between the $1,000 cost of the mortgage and the $900 bid price is a bad debt, that is, of course, if it can't be collected from the debtor. Then, if the taxpayer can prove that the property was worth only $700, he has a $200 capital loss in addition, that is the difference between $900 and $700. In other words, in this particular case, the taxpayer breaks up his loss into two sections, he takes $100 as a bad debt and $200 as a capital loss; and the latter amount is subject to the capital loss provisions.

MR. SALVATORE: Mr. Rolnik, I would like to go back to the question of when worthlessness occurs. What progress has been made in establishing any principles?

MR. ROLNIK: I am afraid we are no better off on this subject of worthlessness than we are on the subject of stock dividends and on the subject of reorganizations that we have been discussing tonight. We can say, merely, that in the case of worthless securities, the principle has been established that worthlessness must be based on the rule of common sense, a pretty good rule but very difficult to apply in particular cases.

As an application of this general principal, for example, we have the rule that the stock of a company is not worthless if the company is still operating. This is generally true—the theory is that so long as the company is operating, there is life and hope for living. The stock is not worthless if the company is operating, regardless of the financial condition of the company, and regardless of how low the price of the stock has fallen in the market. Now this is the general principle, that while a company is still alive—that is operating—there is as yet no worthless stock. Yet, there are exceptions. I know of cases where, even though the company was operating, worthlessness of the stock was proven because it could be shown that the operations were doomed to failure.

We once thought we had a workable rule when the courts laid down the principle that worthlessness must be proved by an identifiable event. However, we soon found that in many cases there is no one identifiable event that proves worthlessness in a particular year; there is a long series of events, no one of which is decisive. You cannot reconcile all the decisions on the subject of worthlessness. In the first place each depends on a set of facts which cannot, of course, be exactly duplicated in any other case. Moreover, it is more than the facts themselves that were involved in the decided cases. Each decision depends on the manner in which the facts were presented; on the skill of the opposing counsel; and on the impression the witnesses make on the court. All of this doesn't appear in the decision. Equally important, a particular decision may depend on the temper of the times, and on the

political and economic philosophy of the judge who rendered the decision. As a result of all this, controversies with the Treasury have degenerated into the fine art of hair-splitting, both parties to the controversy being equal offenders.

CHAIRMAN KLEIN: That about ends the formal session of our Committee, with perhaps two observations before we go to questions.

It seems to be necessary to reiterate what has been said before about not interpreting what has been said by the members of this Committee as anything in the nature of a legal opinion. So far as anything was said regarding foreign personal holding companies, it is also understood, I hope, that no advice was given, because I just would hate to have any member of the Committee have to make a disclosure because of what he said here tonight.

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THE PROBLEM of INFLATION as IT AFFECTS BUSINESS TODAY

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Introduction

By John T. Madden, C.P.A.,
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Mr. President, Guests, and Fellow Members of The New York State Society of Certified Public Accountants:

The speaker this evening is no stranger to the members of this Society. We know from past experience that his exposition is always clear, despite the highly technical nature of the subject matter. He is always generous in answering questions after his address, a privilege which he will accord this evening to those who will send up questions. The Problem of Inflation as It Affects Business Today is the topic of the evening, and the views of the speaker on this question will be helpful to us in forming our own conclusions on this problem. We know that some of our clients rushed into the commodity and securities' markets last Spring, and we know that the downward adjustments in the year-end statements will be large in number and amounts.

I might present Dr. Marcus Nadler to you as a Professor of banking in New York University; or as the author of three scholarly and widely read volumes on international finance; or as a consultant to governmental or private banking interests; but I prefer to present him as my most severe critic and valued academic colleague.

Presented at a Meeting of The New York State Society of Certified Public Accountants held on January 10, 1938.

The Problem of Inflation as it Affects Business Today

By DR. MARCUS NADLER

IN spite of the recent sharp decline in prices of securities and commodities, there are still a number of people in the United States, among them outstanding economists with international reputation, who maintain that this country is bound to go through a period of inflation.

Inflation is a very serious disease. By "inflation" I mean a sharp rise in the price of commodities or a sharp decline in the purchasing power of the dollar. If you study the records of the various European countries, you will find that the downfall of democracy was caused first and foremost by inflation, because inflation wipes out the middle class, the backbone of any nation.

Inflation is of the utmost importance to the accountant and the business consultant. Obviously, if we are in for a period of inflation, large inventories are warranted, the holding of government securities is a mistake, and people should seek security in equities and in commodities.

Now let us analyze this problem of inflation. Why is it that people say that inflation is bound to take place in this country? Professor Kemmerer, for example, one of the outstanding teachers of economics in the United States, in the December issue of the Atlantic Monthly, reaches the conclusion that wholesale prices in the United States are bound to increase by 96 per cent over and above the level of last September, and that retail prices are bound to increase by 98 per cent.

The reasons why the talk of inflation persists with us are these:

(1) The devaluation of the dollar and the large increase in the amount of gold.

(2) The huge silver purchases of the Administration.

(3) The huge deficit of the government's budget.

(4) The large volume of excess reserve balances.

(5) The low money rates.

These five factors, it is argued, are bound to bring about a sharp increase in commodity prices. Let us analyze them carefully.

Let us take first the element of gold. It is commonly stated that when a currency is depreciated, when the gold content of a currency is reduced, this is bound to bring about a corresponding increase in prices of commodities. What, however, happens, when the gold content of currencies is reduced in all countries alike? If you sit down to a friendly game of poker and you call the blue chips a nickel, so long as everybody considers a blue chip a nickel it makes no difference to anybody. Furthermore, if a decline in the gold content of the currency is bound to bring about an increase in prices of commodities, how do you explain the recent sharp decline in commodity prices?

Isn't it a fact rather that commodity prices depend more on demand and supply and on the cost of production than on the gold content of the currency. Hence, agricultural commodities today are lower in price than they were in March, whereas a number of manufactured goods are higher today than they were in March, because of the increase in

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the cost of production, notably labor costs.

To look merely at the gold content of the currency and to say the effect on prices will be so-and-so, makes the entire problem of prices altogether too easy. However, still another argument is advanced. It is said that whenever the amount of gold in the world increases sharply, this is bound to bring about an increase in commodity prices and evidence to prove this point is brought forth. It is pointed out, and correctly so, that from 1896 to 1913 the world witnessed, on the one hand, a sharp increase in the amount of gold produced, and, on the other hand, a sharp increase in prices of commodities. All of you know how the discovery of gold in the Klondike and the discovery of gold in South Africa materially increased the amount of gold which, in turn, was followed by an increase in prices of commodities.

The present production of gold is about three times as large in value as during the early twenties. The amount of gold in the world is tremendous, and the question is asked, "won't this increase in the amount of gold, coupled with the increase in the production of gold, bring about a sharp increase in commodity prices?" Let us look at this point.

In the past, from 1896 to 1913, when new gold was discovered, a considerable portion of it was sold to the central banks. There it formed the basis for bankers' balances, on which a multiple expansion of currency could take place. At the present time, on the other hand, gold is sterilized. Think of it in these terms. At the present time the United States has $12,700,000,000 of gold, or more gold used for monetary purposes than existed in the entire world prior to the World War. But out of the $12,700,000,000, over six billion dollars are sterilized—$1,200,000,000 in the inactive gold account in the Treasury, $1,800,000,000 in the Stabilization Fund, and over three billion dollars of gold sterilized when the reserve requirements were raised to the full extent permitted by law.

Dead people tell no tales. Sterilized gold is dead gold and doesn't work.

At the present time we find that the United States has built a very nice burial place for the gold, primarily in order to fulfill one passage of the Bible, "From earth to earth." The gold comes out of the ground all over the world, in many places where the government pays a bounty for a production of gold, in order to be buried in Fort Knox, with the people of the United States paying the funeral expenditures. (Laughter)

And not only is gold sterilized in the United States, but in other countries, too. According to the latest statement of Sir John Simon, Great Britain holds today approximately four billion dollars of gold, of which two billion dollars are sterilized.

Huge amounts of gold have been sterilized also in Holland and in Switzerland. And so long as a large part of the gold in the world remains sterilized, is not used, it cannot have an inflationary effect on credit, business or on prices.

Let us now take the second point. It is true that the silver purchase program instituted by this Administration is the most asinine ever carried out in any country, and I am quite certain that when the next generation studies the silver purchase program of the United States, they will explain it in this way: they will say that around 1934 Prohibition was repealed and that the silver purchase act was the result of the repeal of the Prohibition Law. But in spite of it all, is it true that the United States is using silver and issuing silver certificates, which to me are the same thing as greenbacks? It is not true. If you take the trouble to study the total amount of silver certificates outstanding at the present time, as compared with 1934, you will find an increase of $780,000,000,

but during the same period the amount of national bank notes decreased by seven hundred million dollars.

What the United States is doing with silver is merely repeating the old trick of wampum in the early days of this country. Traders would take wampum and sell it to the Indians for valuable merchandise. Now we are buying wampum, which is called silver, in exchange for American securities or commodities. So far, however, silver has not been used as a basis for currency. The silver certificates have merely taken the place of the national bank notes, and so long as this takes place, there is no danger of inflation.

That brings us to the third point, namely, the deficit of the budget. I take it that as accountants you study through that voluminous book, the Budget of the United States. (Laughter) I take it that you have enjoyed yourselves very much in finding that the deficit of the United States during the present fiscal year will amount to $1,090,000,000. At this time last year "a layman's balancing of the budget was presented." For next year the deficit is estimated at $950,000,000,

One thing is certain. If inflation is brought about in any country, it is caused by the deficits of the government, and so far in this country we have followed the policy of bigger and better deficits. You know what the public debt of the United States is today. But here, too, it is not wise to reach immediate conclusions without further investigation, to state that the budget will show a large deficit this year, the budget will show a large deficit the following year, and hence inflation is inevitable. Let us see.

Why and when is a budget inflationary? A budget deficit is inflationary only when the government meets its deficit through the sale of bonds to the banks. The purchase of government securities by the banks creates on the asset side of the banks' balance sheets, government securities, and on the liabilities side, government deposits. As the government spends these deposits, they become private deposits. Private deposits are purchasing power. It is, therefore, only when the deficit of the government is met through the sale of bonds to the banks that a deficit of the budget is inflationary; otherwise it is not.

How does the government meet its deficit at the present time? Is the government under obligation to sell new bonds to the banks, or is the government entirely free from the sale of bonds in the open market? You know that the government does not have to borrow at all in the open market. The government has a new nest egg called social security income, and as accountants you know that the payment of taxes results in a decline in deposits of your clients and an increase in deposits of the government. The government takes these deposits and meets its expenditures. At the same time they print new bonds, 3 per cent bonds in the case of the old age pension fund, 2½ per cent bonds in the case of the unemployment trust fund, but these bonds are kept by these two funds without creating new deposits.

Someone may say: What will happen when the expenditures of these funds are larger than the revenues? Well, that will arise only about thirty-five years from today, but in the meantime we are on a twenty-four-hour basis, and who cares what will happen thirty-five years from today? (Laughter and applause)

Let us study the budget for 1938-39. During the fiscal year 1938-39, the government will have a deficit of $950,000,000, but in spite of this deficit the government will have from the various trust funds a sum of $230,000,000 with which to repurchase government securities now held in the open market. The government, therefore, can increase its deficit from $950,000,000 to $1,-

180,000,000 without having to borrow a cent from anybody.

And that is not all. The government has another nest egg, and that is the sale of baby bonds (savings certificates), which are not bought by the banks. They are bought chiefly by individuals of small means. That is not inflationary because, if I buy, let us say, $750 of baby bonds, I turn over my deposits to the government. My private deposits become government deposits, and, as the government spends them then, of course, they become private deposits, but no increase or decrease takes place.

During 1937 the government sold five hundred and ten million dollars of baby bonds, so that next year, even if the deficit of the government should amount not to $950,000,000 but to $1,600,000,000, the government would not have to sell any new bonds to the banks.

The deficit of the government was inflationary so long as the banks bought large amounts of government bonds. Now, however, the government can finance its deficits through the sale of baby bonds or from social security taxes and the deficit of the government is not any more inflationary.

We come, then, to the fourth item, and that is low money rates. Those of us who are old enough, who were going to school about fifteen years ago, were told that low money rates if continued over a period of time inevitably lead to expansion or overexpansion. This is perfectly true when you have confidence and when the outlook for profit is good; otherwise money lies idle, and idle money means idle people.

Let us digress for a moment. In the old days—very, very old days—in the twenties (laughter)—London and New York acted as international bankers of the world. Whenever there were idle funds in any part of the world, they were transferred to London or to New York, and these two centers, acting like banks, placed these funds all over the world, wherever there was any need for any money. Capital was truly international in character, and went from capital-rich to capital-poor countries or from countries with low money rates to countries with high money rates.

This capital was used to develop the natural resources of the world, and to increase the standard of living of the population. At the present time, in the absence of confidence, what happens? The money accumulates in New York or in London, and is kept as idle gold. When confidence existed, this money was used. It was productive, created new wealth. At the present time, because of lack of confidence capital remains idle, irrespective of the low money rates.

After all, the cost of money is only one element in the cost of production. Everything remaining equal, low money rates will induce expansion, but, assume you can borrow money at 2 per cent, but you find out that your cost of labor is so much higher, that your cost of raw materials is so much higher, naturally, you will not use your idle money if you see no profit. That is one of the reasons why the building industry has not recovered in the United States; not because of high money rates, but because of the high cost of production.

The index of construction costs in September, 1937, was 244 as compared with 208 in September, 1936. That is the reason why building did not develop. Money rates play only a minor role, and I am inclined to believe that this policy of low money rates has been greatly overrated.

The last factor we come to is that of the excess reserve balances, which represent the idle money placed by the banks with the reserve banks, on which a multiple expansion of credit can take place. It is generally said that these excess reserve balances are bound to cause an increase in the volume of loans, and that this in-

crease in the volume of loans is bound to bring inflation with it.

Let's look at this for a moment. Loans may be divided in two types, commercial loans and speculative loans. When a merchant or manufacturer goes to the bank and borrows money, he usually has a purpose for it. He takes this money and uses it in his business, thereby increasing production, thereby increasing the amount of commodities available for sale. Business loans are not inflationary in character because, on the one hand, you have an increase in deposits which loans create, and on the other hand, you have an increase in commodities offered to the public for sale. A sharp increase in business loans accompanied by an increase in business activity may lead to volume inflation but not to price inflation.

Speculative loans are in a different category, but today we know that the Board of Governors of the Federal Reserve System can regulate and control speculative loans without in any way affecting business loans. The Board can, if it wishes to do so, raise margin requirements to 100 per cent and thereby prevent any use of bank credit for speculative purposes.

Hence, we may reach the following conclusion, that neither the devaluation of the dollar nor the huge increase in the amount of gold stocks is speculative in character so long as the gold is not used. The budget deficit is not any more inflationary in character, and it is doubtful whether the low money rates and the excess reserve balances can bring about a sharp increase in commodity prices.

This, however, does not mean that our country is not confronted with any danger of inflation. During the recent recession a number of our legislators, such as Senator Thomas, Congressman Patman, Congressman Voorhis, have again been seeking the mystery of life, the mystery of recovery, and they find only one answer, to prime the pump through the issuing of paper money. This, to me, is a real danger because on the surface a plausible case can be made out for the issue of paper money instead of the selling of bonds, and I believe it is the duty of every good citizen, no matter what his profession may be, to fight the issue of paper money, because it is highly dangerous not only to our national economy but also to the democratic form of government.

Not only is it the duty of every good citizen to fight the issue of paper money, but also to fight any banking legislation which may lead to such a procedure. At present a number of legislators are endeavoring to nationalize the Federal Reserve banks and empower the Board of Governors to raise reserve requirements to any extent. This, of course, will make the Federal Reserve banks a typical government institution, with the power to finance the needs of the government through the issuance of paper money. It is my honest opinion that every thinking citizen should take an active interest in proposed banking legislation in order to prevent the adoption of laws which may be harmful to the country. Inflation in the various European countries was created by government control over the central banks, which enabled them to finance their needs through the issue of paper money. If no paper money is issued, (and I, for one, see no reason for a further devaluation of the currency), no price inflation need be feared. With 10,000,000 people unemployed and with factories working at less than capacity, price inflation is almost inconceivable. What is needed is greater production, better distribution, and greater consumption.

Without inflation, what can we expect of the future of business in this country? Obviously, I am not the seventh son of a seventh son, but this I know, that the fundamental economic factors in the United States are sound. We have not overdone anything at all. We have not

overdone anything by way of overexpansion of the capital goods industries—certainly not in the building industry, certainly not in speculation with borrowed money. The banks are in a sounder position than they have been since 1920. Our foreign trade is not inflated by foreign loans and we as a nation are, to a large extent, economically self-sufficient, depending primarily on our own domestic market and much less on foreign markets.

What this country is suffering from in my opinion, is a paralysis of confidence, which keeps money and men idle. Given some restoration of confidence we undoubtedly will find a slow upturn of business, maybe at the end of this month, maybe at the end or the middle of next month. This, in turn, ought to be followed by a more moderate upswing in March or in April, and then progress will depend on whether the capital market and the capital goods industries can be revived. If confidence in the country can be restored, I am confident that the capital goods market will be revived and that the second half of 1938 will be substantially better than the first half of the present year.

I thank you. (Applause)

Questions and Answers by DR. NADLER

QUESTION: The U. S. A. takes more goods from Brazil than the U. S. A. sends there, thus the government of Brazil gets much in foreign exchange credits here. The U. S. A. State Department does not press the matter of getting Brazil's defaulted bonds paid to Americans so that the present foreign exchange credits go to motor car manufacturers to the direct detriment of the unfortunate investors. What would you suggest should be done in this situation? Certainly foreign governments should not be able to get away with depressing our own investor's securities. Please suggest how the inert State Department can be compelled to do something for America's investors in the now almost worthless securities.

ANSWER: Now, let's look at it. Briefly stated, the question is this: Since we export less to Brazil than we import from Brazil, and Brazil has a favorable trade balance with us up to about fifty to seventy million dollars a year, why don't those Brazilians pay us their debt, and if they don't want to pay, why not clamp down a clearing arrangement as England or other countries have done, and make them pay it? That is the question, is it not?

Now, you happened to pick out one country where we have an unfavorable trade balance. If the United States clamps down a clearing arrangement on Brazil, we can force the Brazilians to pay us, and not the British; and then the British will clamp down a clearing arrangement on Argentine, Uruguay, and other countries, and we will have played the role of the dog in the manger. You can not send down marines to collect your debts, and, of course, always bear in mind that trade to us is of greater importance than the income on foreign securities, which is in sharp contrast to the situation in Brazil.

QUESTION: You speak of the building industry lagging. Isn't there a surplus of (1) office space, (2) a surplus of commercial buildings with manufacturing privileges, also (3) vacant stores on good shopping parts of Fifth Avenue?

ANSWER: Well, that is all true, but New York is only one part of the country, and I believe that the President correctly stated a few weeks ago that the United States is short of about 5,000,000 dwelling units, and I also know this, that perhaps in no civilized country in the world will you find so many slums as you find in the United States. The reason why building does not go ahead (and it did go ahead fairly well the first half of last year) is because the carpenter was not satisfied with his previous wages and wanted more. If the cost of building should go down, then in all probability we will find a material improvement of building activity in the United States, not in Wall Street and not on Fifth Avenue, but throughout the country where there really is a shortage of housing.

QUESTION: To what proportion do you think the federal government will eventually, with ten years more of New Deal theories, repudiate or devaluate its obligations? Is 33⅓ per cent too high to contemplate?

ANSWER: Well, of course I could answer this very simply. Who cares what is going to take place ten years from today? But let's look at it from the serious angle. The United States devalued the dollar, and everybody said it was a repudiation. True, if you look at it from the purely legal point of view, the abandonment of the gold standard is an act of bankruptcy. If you look at it from a purely legal point of view, Great Britain committed an act of involuntary bankruptcy in 1931 and the United States committed an act of voluntary bankruptcy in 1933, but in equity there is no repudiation and no bankruptcy.

If you bought a government bond in 1926 with the government bond containing the gold clause, you paid not in gold, you paid in dollars; if the bond matures in 1937, you still are paid in dollars, and the purchasing power of the dollar in 1937

was not smaller than in 1926; hence, has the holder of the bond suffered any decline in purchasing power because of the devaluation?

I personally believe that the deficits of the United States budget will continue for a long period of time, certainly the next three years. The President himself stated the other day that one cannot expect a reduction in the expenditures below seven billion dollars, but if you look at social security revenues as nothing but taxes, the government budget is already balanced, and social security, the way it is, is nothing but a tax.

QUESTION: Will you please explain what is meant by gold sterilized?

ANSWER: I believe I can explain sterilization of gold much better on the blackboard than by merely talking. Let us take the three agencies involved in sterilization of gold. We have first the Treasury; secondly, we have the Federal Reserve Banks; and the third one is the commercial banks. These are the three agencies involved in the sterilization of gold.

Let us assume that I, as an individual, bring in $3,000,000 of gold into the country. I have to sell it to the Treasury, which means that the Treasury on the asset side has three million dollars of gold. Is that true? The Treasury gives me a check drawn on itself which I deposit at my bank. This in turn increases my deposits. Is that clear? I have received a Treasury check, and Treasury checks are federal funds. My bank in turn deposits this check with the Federal Reserve Bank, which gives it plus 3 reserve balances. (Under assets)

On the books of the Federal Reserve Banks on the liability side we find plus 3 reserve balances, minus 3, a decline in the deposits of the Treasury with the Federal Reserve Bank.

So far as gold came into the country and was not sterilized, it created an increase in deposits as well as an increase in reserve balances. The reserve balances are the foundation of the American credit system, because upon it you can have a multiple expansion of credit.

Now, let us see how gold is sterilized. The Treasury wishes to prevent the gold from creating excess reserve balances. The Treasury then does this: It sells Treasury bills, which means that so far as the Treasury is concerned, on the liability side we have Treasury bills plus 3. The Treasury bills sold by the Treasury are a liability of the Treasury. These bills are bought by the banks where we have on the asset side, Treasury bills. The banks pay to the Treasury for the Treasury bills by checks on the Reserve Banks, which means that on the books of the Reserve Banks, reserve balances decrease while Treasury deposits increase.

As far as the commercial banks are concerned, we have an increase as well as a decrease in reserve balances, which wipes itself out. As far as the Reserve Banks are concerned, we have an increase and a decrease; as a matter of fact, simply this: The Treasury has gold: The Treasury has Treasury bills outstanding. No excess reserve balance is created. Sterilization, therefore, means that the Treasury through the sale of Treasury bills prevents gold from becoming the basis for excess reserve balances. An importation of $3,000,000 of gold would have the following effect:

A. Prior to Sterilization

Treasury		**Reserve Banks**		**Commercial Banks**	
Gold .... +3			Reserve Balances +3	Reserve Balances +3	Deposits +3
Deposit with Reserve Bank .. —3			Treasury Deposits —3		

hence an increase in deposits as well as an increase in reserve balances.

B. After Sterilization

Treasury		Reserve Banks		Commercial Banks	
Gold .... +3	Treasury Bills ... +3		Reserve Balances +3	Reserve Balances +3	Deposits. +3
Deposits with Reserve Banks.. —3			Treasury Deposits —3	Treasury Bills ... +3	
Deposits with Reserve Banks.. +3			Reserve Balances —3	Reserve Balances —3	
			Treasury Deposits +3		

Net effect

1. As far as the Treasury is concerned
   a. An increase in gold
   b. An increase in the public debt (Treasury bills)
2. As far as the Reserve banks are concerned
   — no change
3. As far as the commercial banks are concerned
   a. An increase in deposits
   b. An increase in the holdings of government securities.

There are several ways to sterilize gold.
I have explained only one method.

Question: Is there any country in the world where the budget is balanced, where there is no unemployment problem, whose permanent, economic position is better than the United States?

Answer: Yes, there is a country where the budget is balanced, and that is Sweden, where the number of unemployed is rather small, whose financial and economic position is better than that of the United States. It is worth while to dwell on this topic.

If you study the financial history of Sweden and that of the United States, you will find that both countries did about the same thing until about a year ago, with this difference, that Sweden realized that the budget had to be balanced, and they balanced it last year, and this year they have a surplus. In our case, we merely say, "The budget will be balanced next year," but next year, as tomorrow, never comes. The fact that the government did not balance its budget during the fiscal year 1936-37, a very good year, in my opinion was more responsible for the fear of inflation than any other factor in the picture.

Question: It has been reported that since 1929 there has been a liquidation of private debts to the extent of twenty billion dollars, which has been replaced by government loans. Is that true?

Answer: It undoubtedly is true that a liquidation of private debts has taken place and that the government debt has increased by twenty billion. If I understand this question correctly, it amounts to this: There is a theory today that a government budget should be used as an element of credit control and of influencing business. In poor times, when the volume of loans and deposits is decreasing, the government should have an unbalanced budget, have a deficit, sell the bonds to the banks and thereby create new deposits. On the other hand, when business has improved the government should balance its budget and when business is good the government should have a surplus in order to be able to retire the public debt and in order to reduce the volume of deposits. Sweden lived up to this theory both as

far as unbalancing the budget is concerned, as well as balancing the budget. We like to go tobogganing, but only downhill, we don't like to drag the sled uphill; we like to unbalance the budget because it is easy, but to balance the budget is an entirely different proposition. That is being postponed.

QUESTION: Since restoration of confidence is the crux, who will, if at all, restore confidence, and how? What or who in your opinion is responsible for this lack of confidence that you spoke of? If the confidence you speak of is not returned, do you feel the government is justified in increasing WPA expenditures, CCC expenditures, etc., by increasing the deficit? What will be necessary to cure the paralysis of confidence that now afflicts the country? What, in your opinion, can be done by government, business, and labor, and accountants, to revive the confidence you find so necessary to recovery?

ANSWER: One could, of course, be facetious in answering the questions of confidence but I know that times are too serious to be facetious. In my opinion, if the Congress stops fiddling and sits down to help recovery—and by that I mean this: If the Congress should definitely pass a bill modifying the undistributed corporate surplus tax (and they themselves said that in many parts it is not sound), if they should modify the capital gains tax and indicate that they are more intent on working toward recovery, than on reform, you can have a return of confidence almost overnight.

In my humble opinion, if the government would once show that they are interested in recovery and not so much in reform, you can have a very sharp recovery in the country, because all the underlying fundamentals in the country are sound, except psychology, and you know how rapidly psychology can change. If you left the country for a little holiday before Labor Day and you came back after Labor Day, why, you wouldn't have recognized the same country.

QUESTION: Is not the purchase of foreign gold and silver equivalent in effect to foreign loans of the 1920's?

ANSWER: No, just the opposite. A number of people in the United States labor under the delusion that gold comes to this country because we pay the highest price for it. Most people say that since the United States is the only country where the price of gold is fixed, and this price is so high, gold comes to the United States. But suppose I were to say to myself, "I want to buy a nice home in the country." Could I do it if I hadn't any money? The same applies to the United States. How could we pay for five billion, six hundred million dollars of gold if we didn't have an excess of exports over imports of that amount? We know that the invisible items are about balanced. Why, then, did gold come to the country? Gold came to the country because the foreigners are more optimistic on the future of the United States than on their own country. Foreigners place money in the United States because they regard it the safest place in the world. Foreigners shipped us five billion dollars, which represents a loan to the United States, in the form of bank deposits in the United States, the purchase of stocks and bonds. I doubt very much whether we will ever lose a substantial portion of this gold. In my opinion, if this country should lose a billion dollars of gold, it would be a just cause for the President of the United States to declare a Thanksgiving holiday. We have it, and it is going to stay here.

QUESTION: What did you mean by the statement, low money rates are being greatly overrated?

ANSWER: By that I simply meant this: Many economists believe that the only way to cure a depression is to make money rates very low and everything will right itself. If money goes down to a low enough point, people will begin to borrow, the capital market will be revived, and business will begin to hum.

Experience from 1931 to 1938 has definitely proven that the effectiveness of low money rates is greatly overrated.

Question: What steps would you recommend to Congress and to the Executive in order to accurately balance the budget?

If our national income is going to be about seventy billion dollars a year, we cannot afford to have expenditures of seven billion dollars by the federal government, which as you know represents ten per cent of the national income. To this should be added an additional fifteen per cent of the national income that is absorbed by the states and municipalities. With an income of seventy billion dollars, twenty-five per cent going to the tax collectors, I doubt whether we can in this country support twenty-four million running automobiles, build homes, and maintain the standard of living. The answer to the question is, either cut expenditures or increase the national income. To increase the national income through inflation of prices doesn't solve the problem at all; it merely breaks the middle class.

The answer, then, is reduce your expenditures. I, for one, do not see any reason at all why we couldn't go along fairly satisfactorily on a five billion dollar budget, but go and tell that to the politicians.

Question: If better business is not developed by the summer of 1938, may we expect the government, because of many Congressional relations, to force the appearance of prosperity by inflationary measures, and what form are these measures likely to take?

Answer: I agree with this. In my opinion, if business does not improve by May or June, the hypodermic needle will be applied again, but, you know the effects of the hypodermic needle are not everlasting.

Question: Does not the United States need or depend upon its export volume to maintain a financial equilibrium? In effect, does not the United States have to sell so that it may be enabled to buy? If the United States cannot be self-sufficient, does it not mean it would have to dissociate itself from world trade?

Answer: What I said is simply this, that of the major countries in the world, the United States is more economically self-sufficient than any other. In Great Britain you sit down to breakfast. The bacon is imported, the eggs are imported, the bread is imported, the coffee, and the sugar, and the milk are imported, and in this country, outside of the coffee, sugar and the pepper, everything is produced at home. The United States is more economically self-sufficient. I personally believe in international trade because I believe in the principle of division of labor.

I believe that a country ought to produce what it is best qualified to produce and to buy from other countries what other countries are best qualified to produce. Unfortunately, this is not a trend of the world today. You probably have heard of the trend towards economic self-sufficiency, where countries which haven't got enough milk to feed the babies, make fibre out of milk, and where countries pride themselves because they have guns but no butter.